CITY OF SAN JOSÉ, CALIFORNIA

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June 15, 1987

Honorable Chairman and Members
of the Redevelopment Agency Board
801 North First Street, Room 600
San Jose, CA 95110

Transmitted herewith is a report on *An Audit of the Redevelopment Agency's 20% Housing Program.* This report is in accordance with City Charter Section 805(a).

An Executive Summary is presented on the blue papers in the front of this report while an Administration response is shown on the yellow pages preceding the Appendices.

In addition, we have included some comments on the Redevelopment Agency's response. These comments are on the green pages immediately following the Redevelopment Agency's response.

I will present this report to the Finance Committee at its June 17, 1987 meeting. If you need additional information in the interim, please let me know. City Auditor staff who participated in the preparation of this report are Jeffrey Mikles, Mike Edmonds, Ruth Garcia, Janet Cook, Taylor Willingham, and Juan Bettaglio.

Respectfully submitted,

Gerald A. Silva

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GS:mlt
EXSUM019

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OFFICE OF THE

CITY AUDITOR

AN AUDIT OF THE REDEVELOPMENT AGENCY'S 20% HOUSING PROGRAM

A REPORT TO THE

SAN JOSE

CITY COUNCIL

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EXECUTIVE SUMMARY

In accordance with the City Auditor's approved 1986-87 Workplan, we have completed an audit of the Redevelopment Agency's 20% Housing Program. This is the first report in a series of Agency audits. Subsequent reports will be on the Agency's Relocation Program and Capital Budget.

We reviewed the Redevelopment Agency's 20% Housing Program to determine if the Agency has 1) sufficiently planned for the use of available funds and 2) implemented adequate internal controls to ensure that available funds and assets are properly safeguarded and effectively utilized. The results of our audit are as follows:

- Improvements are needed in the Agency's 20% Housing Program planning process.
- The Agency needs to implement adequate and sufficient controls over the 20% Housing loan approval process.
- The Agency needs to implement adequate and sufficient controls to insure that loan documents are properly prepared.
- The Housing Program needs to implement a monitoring program.
- The Agency needs to implement adequate and sufficient accounting controls to safeguard its assets and prevent errors.

Improvements are Needed in the
Agency's 20% Housing Program Planning Process

The Redevelopment Agency has developed policy statements and evaluation criteria for its 20% Housing Program. In addition, the Redevelopment Board has adopted Redevelopment Plans for designated redevelopment areas. However, our review of the 20% Housing Program revealed that these pronouncements are not specific as to what the housing needs of low and moderate income persons and families in San Jose are and how 20% Housing funds can best be used to satisfy those needs. In addition, the Agency has not developed adequate plans, procedures and budgets to accomplish the goals of its Housing Program. Absent specific plans and adequate procedures, the Agency is exposed to the following risks: 1) the housing needs of low or moderate income persons or families may not be met, 2) opportunities to leverage 20% Housing funds with Federal and State funds may be lost, 3) linkages with other City departments may be lacking, and 4) the Housing Program's current organizational placement and degree of top management involvement may be inadequate.

The Agency Needs to Implement Adequate and Sufficient
Controls Over the 20% Housing Loan Approval Process

The Redevelopment Agency does not have adequate or sufficient controls over the 20% Housing loan approval process. As a result, the Agency is exposed to the following risks: 1) Funds may not be used effectively to benefit low or moderate income persons or families, 2) uncollectible or undesirable loans may be made, 3) Agency management and Board may lack sufficient information to properly evaluate loan proposals and 4) Agency staff may be inconsistently or unfairly evaluating loan proposals.

The Agency Needs to Implement Adequate and Sufficient Controls to Ensure that Loan Documents are Properly Prepared

The Redevelopment Agency has not implemented adequate or sufficient controls to ensure that all necessary loan documents are completed and properly prepared prior to executing agreements. As a result, the Agency is exposed to the following risks: 1) loans may be invalidated because of significant errors on loan documents, 2) the Agency may not be complying with Federal and State lending laws and 3) some of the Agency's loans may not be enforceable.

The Housing Program Needs To Implement a Monitoring Program

The Housing Program is not monitoring borrowers to ensure that they are complying with all the terms of their loan agreements. As a result, the Agency is exposed to the following risks: 1) borrowers may not be in compliance with their loan agreements, 2) 20% Housing funds may not be used as intended and 3) loans may not be insured against fire losses.

The Agency Needs to Implement Adequate and Sufficient Accounting Controls to Safeguard Its Assets and Prevent Errors

The Redevelopment Agency has not implemented adequate or sufficient accounting controls over its 20% Housing Program. As a result, the Agency is exposed to the following risks: 1) staff may engage in improper activities without being detected, 2) financial records may be materially inaccurate and 3) important loan documents may not be adequately safeguarded.

RECOMMENDATIONS

We recommend that the Agency:

Recommendation #1:

Develop and implement a formal assessment process to determine the City's low and moderate income housing needs. (Priority 3)

Recommendation #2:

With the assistance of the Agency Board, the Department of Neighborhood Preservation, advocacy groups, developers, and non-profit corporations develop priorities for addressing the City's most critical low and moderate income housing needs. (Priority 3)

Recommendation #3:

Develop one-year and five-year plans and budgets for addressing the City's most critical low and moderate income housing needs. These plans should include:

- Using a Request for Proposal process to meet identified low and moderate income housing needs
- Using 20% Housing funds to provide replacement housing for those residents displaced by redevelopment activities
- Seeking opportunities to leverage 20% Housing funds with available Federal and State funds
- Coordinating with other City departments. (Priority 3)

Recommendation #4:

Assign a higher priority to the 20% Housing Program and elevate it to a higher organizational status within the Agency. (Priority 3)

Recommendation #5:

Develop written procedures for analyzing and approving housing proposals. These procedures should ensure that housing proposals are analyzed consistently and fairly and that 20% Housing funds are used effectively. (Priority 2)

Recommendation #6:

Provide training to staff on procedures for analyzing and approving housing proposals. (Priority 2)

Recommendation #7:

Periodically review the guidelines that commercial lenders use to qualify buyers for home mortgages. Based on this information, adjust its own guidelines for determining the affordability of proposed housing units to moderate income buyers. (Priority 2)

Recommendation #8:

Develop necessary forms for analyzing and approving housing proposals. These forms should adequately document the loan analysis process and facilitate supervisory review. (Priority 2)

Recommendation #9:

Assign responsibility for reviewing loan analysis and develop forms as a means of establishing accountability over the loan analysis process and subsequent supervisory review. (Priority 2)

Recommendation #10:

Develop and use a Credit Analysis Statement to convey important housing proposal information to Agency management and the Board. (Priority 3)

Recommendation #11:

Develop and implement written procedures for preparing, reviewing, and approving loan documents. (Priority 2)

Recommendation #12:

Formally assign responsibility for preparing, reviewing and approving loan documents. (Priority 2)

Recommendation #13:

Develop and consistently use checklists for ensuring that necessary loan documents are properly prepared. (Priority 2)

Recommendation #14:

Develop and use forms for establishing accountability for the preparation, review, and approval of loan documents. (Priority 2)

Recommendation #15:

Develop and use written procedures and necessary forms to comply with the Federal Truth-In-Lending Law and the California Fair Lending law. (Priority 1)

Recommendation #16:

Develop and use written procedures and necessary forms to ensure that corporate borrowers are properly authorized to borrow in the name of their corporation. (Priority 2)

Recommendation #17:

Develop and implement written policies and procedures for monitoring borrowers. (Priority 2)

Recommendation #18:

Develop schedules for monitoring borrowers. (Priority 3)

Recommendation #19:

Develop and implement reporting forms for communicating the results of its monitoring visits. (Priority 3)

Recommendation #20:

Develop and implement tickler files to remind staff when to monitor borrowers. (Priority 2)

Recommendation #21:

Develop and implement a management information system to provide feedback on monitoring accomplishments. (Priority 3)

Recommendation #22:

Develop an organization plan which adequately segregates functional responsibilities. (Priority 1)

Recommendation #23:

Develop written policies and procedures for all of its accounting activities including the following:

- Maintaining custody of assets and important legal documents
- Reconciling general ledger accounts and subsidiary ledgers on a regular basis
- Reconciling records to actual assets on a regular basis
- Calculating interest payments
- Applying repayments to loan accounts
- Accounting for loans (Priority 1)

Recommendation #24:

Develop necessary forms and procedures to ensure that all work is adequately documented and subsequently reviewed. (Priority 1)

Recommendation #25:

Provide ongoing training to staff on policies and procedures. (Priority 2)

Recommendation #26:

Discontinue the practice of placing money for second mortgages in escrow accounts. (Priority 1)

INTRODUCTION

California Health and Safety Code Section 33334.2 requires redevelopment agencies to set aside 20% of their tax increment monies for the purpose of increasing and improving the supply of housing for low and moderate income persons and families. The law defines moderate income as 80% to 120% of the median county income, and low income as 50% to 80% of the median. The law further defines very low income to be less than 50% of the median county income. TABLE 1 shows the current income limits the Redevelopment Agency uses to define very low, low, and moderate income.

TABLE I

REDEVELOPMENT AGENCY
VERY LOW, LOW, AND MODERATE
INCOME LIMITS

Number of Persons	Income Limits: Very Low Income	Low Income	Moderate Income	Median Income
1	15,100	21,300	36,200	30,150
2	17,250	24,300	41,400	34,500
3	19,400	27,350	46,550	38,800
4	21,550	30,400	51,700	43,100
5	23,250	32,300	54,950	45,800
6	25,000	34,200	58,200	48,500
7	26,700	36,100	61,400	51,200
8	28,450	38,000	64,650	53,900

The State law is very flexible in defining the permissible uses of 20% Housing funds. A variety of activities are allowed including: 1) land acquisition, 2) land improvements,

3) rehabilitation and 4) construction of housing units. Accordingly, the Agency has adopted the following flexible policies to govern how these monies are to be used:

1. As a goal, a minimum of 50% of these funds are to be used for housing that is affordable to low income persons or families, and the remainder are to be used for moderate income persons or families.

2. As a goal, 20% of the low income funds are to be allocated to housing for which the rents will not exceed the fair market level established for the Federal Section 8 Rent Subsidiary Program.

3. Both owner-occupied and rental housing developments are eligible for assistance.

4. As a goal, two-thirds of the funds are to be allocated for new construction projects and one-third for rehabilitation projects.

To meet the objectives of the law and its own policies, the Agency has established an application process to determine funding for housing projects (See Page 14). The Agency has used this process to fund a variety of housing projects designed to increase the City's supply of low and moderate income housing. Since 1982, the Agency has committed over $40 million to developers, non-profit organizations, other City departments, and individual homeowners.

The Agency's assistance has primarily been loans to developers, non-profit corporations, and homebuyers. Housing loans are usually one of two types. The first type is below market rate loans to developers or non-profit corporations. These loans are designed to minimize the costs to a developer on a housing project with the savings theoretically passed on to low and moderate income persons or families in the form of lower rents. The second type is below-market second mortgage loans to low and moderate income persons or families to allow them to purchase housing they otherwise could not afford. In addition, the Agency has funded the administrative costs of private, non-profit organizations that are involved in providing housing to low and very low income persons and families. Further, the Agency has provided funds to the City's Neighborhood Preservation Department. These funds are used in conjunction with the Department's housing rehabilitation programs. Finally, the Agency uses 20% Housing funds to pay for its cost of administering the Program.

The following table summarizes the type of uses of 20% Housing funds from 1982 through 1986.

TABLE II

SUMMARY OF 20% HOUSING FUND USES FROM 1982 THROUGH 1986

Activities	Funds Expended or Committed	Number of Agency Assisted Housing Units: Low Income	Moderate Income	Total
Housing Projects:				
Rental:				
Completed	$ 4,153,878	432	379	811
Under Construction	8,772,000	170	416	586
Commitments	2,468,000	92	0	92
TOTAL	$15,393,878	694	795	1,489
For-Sale:				
Completed	7,021,055	84	88	172
Under Construction	11,694,200	24	301	325
Commitments	2,680,000	53	5	58
TOTAL	$21,395,255	161	394	555
Non-Profit Corporations' Administrative Costs	873,000			
Neighborhood Preservation Rehabilitation Projects	2,728,000			
Housing Program Administrative Costs	474,000			
TOTAL	$40,864,133	855	1,189	2,044

It should be noted that the number of Agency assisted housing units shown in TABLE II is based on the Agency's management reports. Accordingly, the following comments are pertinent:

- The Agency has included in its management reports all of the units built in various housing projects, when only a portion of the units are actually reserved for low and moderate income families. For example, the Agency has reported all 452 units in the Amberwood and Cedar Glen apartment complexes as low and moderate income housing units. However, the Agency's agreement with the developer provides that only 150 of the 452 units are required to be reserved for low and moderate income families.

- The data provided in TABLE II is accurate for the period it represents (1982 through 1986). However, the Agency Board defunded three projects totalling 84 units at its May 7, 1987 meeting.

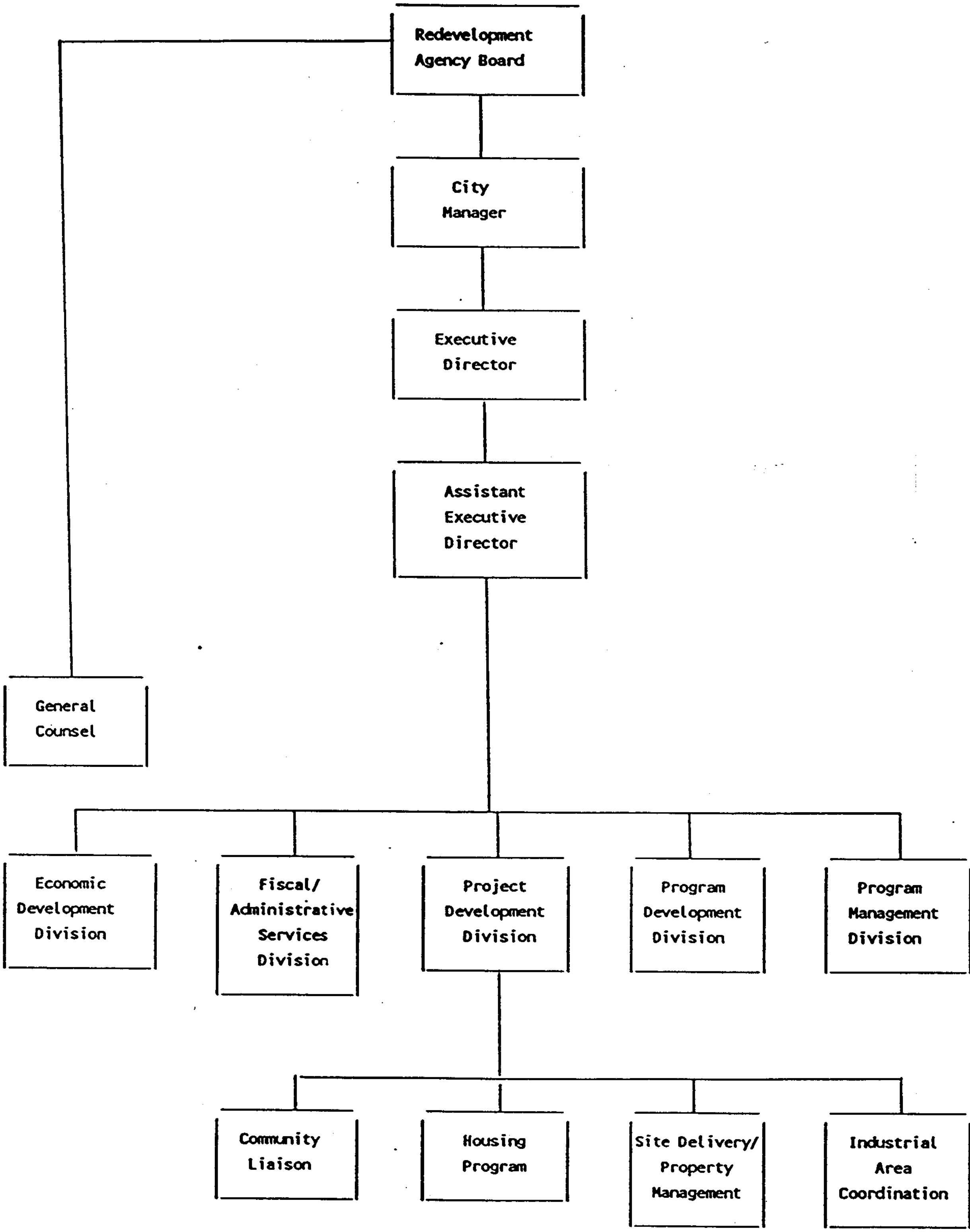
- The number of For-Sale housing units is based on estimates of the number of second mortgages needed for home-buyers. These estimates are periodically adjusted based upon actual loans closed. As of March 31, 1987, several projects have closed; however, the Agency has not adjusted its totals downward to show the actual number of loans closed. For example, the figures for Fairview Park show that 25 low income units were assisted. However, the Agency made only 5 second mortgage loans to low income buyers.

- Our audit revealed that the Housing Program is not monitoring borrowers to ensure that they are complying with the terms of their loan agreements. (See FINDING IV).

APPENDIX B shows the details on the projects the Agency has assisted.

The Housing Program is a component of the Project Development Division. The Program's staffing was recently increased from two to eight positions: 1 Senior Development Officer, 1 Development Specialist, 4 Development Officers, 1 Staff Analyst, and 1 Steno-Clerk. The Program is organizationally located within the Agency as is shown on Page 6.

ORGANIZATIONAL CHART



SCOPE AND METHODOLOGY

We reviewed the Redevelopment Agency's 20% Housing Program to determine if the Agency has 1) sufficiently planned for the use of available funds and 2) implemented adequate internal controls to ensure that available funds and assets are properly safeguarded and effectively utilized.

The Need for Controls

For every governmental or business activity there are associated threats and risks. Threats are potential errors, irregularities, fraudulent activities, inefficiencies, ineffective operations, and other possible problems that can result from specific activities. Risks are the potential losses or damages to an organization resulting from threats. Often times risks are quantified in dollar terms, but non-monetary losses can also result from threats.

Theoretically, each organization devises a system of procedures or controls to mitigate any risks associated with specific threats. To the extent an organization successfully implements sufficient and adequate controls, risks are reduced to a tolerable potential. Conversely, to the extent controls are absent or ineffectively implemented, the resulting uncontrolled risks may not be tolerable.

Methodology

In our audit of the Redevelopment Agency's 20% Housing Program, we identified specific threats associated with the following aspects of the Program:

- Planning for the use of Housing funds
- Analyzing loan proposals
- Preparing loan documents
- Monitoring borrowers
- Accounting for 20% Housing activities

We evaluated the above aspects to identify what controls the Agency has in place to mitigate any risks associated with specific threats. To the extent Agency controls were absent or inadequate, we attempted to identify the resultant risks the Agency was exposed to because of control deficiencies.

We also reviewed the program to determine if the Agency is complying with 1) the State Community Redevelopment Law as it applies to the 20% Housing Program, 2) the Federal Truth-In-Lending law and 3) the California Fair Lending law. Finally, we reviewed the program to determine if the Agency is following sound lending practices in its dealings with developers and low and moderate income persons or families.

During the course of our audit, we interviewed Agency staff; reviewed Agency policies and procedures, applicable legal statutes, project files, and accounting records. We also interviewed staff from the City's Neighborhood Preservation Department, officials from other California redevelopment agencies, Federal and State housing officials and banking officials.

FINDING I

IMPROVEMENTS ARE NEEDED IN THE AGENCY'S 20% HOUSING PROGRAM PLANNING PROCESS

The Redevelopment Agency has developed policy statements and evaluation criteria for its 20% Housing Program. In addition, the Redevelopment Board has adopted Redevelopment Plans for designated redevelopment areas. However, our review of the 20% Housing Program revealed that these pronouncements are not specific as to what the housing needs of low and moderate income persons and families in San Jose are and how 20% Housing funds can best be used to satisfy those needs. In addition, the Agency has not developed adequate plans, procedures and budgets to accomplish the goals of its Housing Program. Absent specific plans and adequate procedures, the Agency is exposed to the following risks: 1) the housing needs of low or moderate income persons or families may not be met, 2) opportunities to leverage 20% Housing funds with Federal and State funds may be lost, 3) linkages with other City departments may be lacking and 4) the Housing Program's current organizational placement and degree of top management involvement may be inadequate.

The Need for Specific Plans and Adequate Procedures

It is a generally accepted business and government practice for administrators to develop formal planning and budgeting processes for discrete programs and functions. These processes normally involve: 1) the identification of a problem or unmet need, 2) the establishment of official policies and priorities and 3) the development of specific plans, procedures and budgets to address identified needs.

The Redevelopment Agency has developed program policies and evaluation criteria for its 20% Housing Program (See Appendix A). In addition, the Agency has used 20% Housing funds for a number of worthwhile housing projects. However, the Agency has not developed the plans, procedures or budgets necessary to effectively administer the program. As a result, the Agency is exposed to the following risks: 1) the housing needs of low and moderate income persons may not be met, 2) opportunities to leverage 20% Housing funds with Federal and State Funds may be lost, 3) linkages with other City departments may be lacking and 4) the Housing Program's current organizational placement and degree of top management involvement may be inadequate.

THE HOUSING NEEDS OF LOW OR MODERATE INCOME PERSONS OR FAMILIES MAY NOT BE MET

In order for the Agency's 20% Housing Program to be effective, the Agency must 1) assess the low and moderate income housing needs of San Jose, 2) develop specific plans to address those needs and 3) develop procedures to ensure the most efficient and effective use of available funds. Our review revealed that the Agency has not adequately developed or implemented these requisite components.

Inadequate Needs Assessment

An essential planning process component for a program such as Housing is to identify the needs of the population to be served. Federal Community Development Block Grant (CDBG) regulations are an example of such an approach for a housing program. These regulations require localities that participate in the CDBG Program to prepare a Housing Assistance Plan (HAP) which must include:

- A needs assessment of lower income households,
- A survey of housing conditions in the City, and
- Goals for housing assistance.

In contrast to the above CDBG requirements, the Agency has not formally assessed the City's low and moderate income housing needs. In addition, the Agency has not established priorities for addressing the City's low and moderate income housing needs. Further, the Agency has not developed long and short term plans and budgets for addressing the City's housing needs.

Finally, it should be noted that the CDBG required HAP is not an adequate or sufficient substitute for an Agency 20% Housing needs assessment. The HAP fails as an Agency housing needs assessment because the last City of San Jose HAP was based primarily on 1980 Census information and did not reflect the housing needs of moderate income persons or families, or groups such as homeless persons.

The Agency could conduct regular and periodic public meetings as one means to assess low and moderate income housing needs. Such meetings could serve as a forum for private citizens, advocacy groups, developers, non-profit organizations and City departments to express their views on San Jose housing needs. The Agency could use the information presented at these public meetings to develop specific plans, procedures, and budgets for future housing projects.

Proposal Solicitation Process Impedes Effectiveness

An additional impediment to the Agency effectively planning to meet specific housing needs is the Agency's housing proposal solicitation process. This process works in the following manner:

1. The Agency advertises that it will be accepting proposals to provide low and moderate income housing.
2. Developers, non-profit organizations, and other interested parties submit proposals to provide low and moderate income housing to the Agency's Housing Unit.
3. Housing staff evaluate the proposals and select the ones that are the most suitable for funding.
4. The Agency Board approves the projects to be funded and the amount of funds to be allocated to each project.

While the application round process has resulted in some worthwhile housing projects, the process does have its drawbacks. Specifically, the process is more reactive than proactive in that developers and non-profit corporations, not the Agency, propose how 20% Housing funds should be used. In addition, the Agency's criteria for evaluating housing proposals does not specify the housing needs that are to be addressed. As a result, the Agency's proposal process provides little assurance that 20% Housing funds are being used to meet the City's most critical low and moderate income housing needs.

Unmet Housing Needs

An example of a critical low income housing need for which the Agency has not adequately planned is permanent replacement housing for the displaced residents of the Guadalupe-Auzerais Redevelopment Area. Had the Agency adequately planned for and provided appropriate replacement housing, 1) the expense of relocating the Guadalupe-Auzerais residents would have been considerably less and 2) approximately $3.2 million of other non-housing funds could have been preserved for capital needs.

The Agency could have reduced its relocation expenses by using 20% Housing funds to satisfy various state Health and Safety Code requirements. Specifically, the Code requires the Agency to use 20% Housing funds to improve the supply of low and moderate income housing. In addition, the Agency is required to replace all of the low and moderate income housing units demolished because of redevelopment activities. Furthermore, the Agency is required to find comparable replacement housing for all the residents displaced as a result of redevelopment activities. The Code specifically provides that 20% Housing funds can be used to meet all of the above legal requirements.

However, because the Agency failed to anticipate or adequately plan for the housing needs of the displaced Guadalupe-Auzerais Area residents, $3.2 million of non-housing funds* were used to pay for relocating those residents.**

Proper Agency planning for the Guadalupe-Auzerais relocations would have had the following benefits:

- Housing funds would have been used for their intended purpose,
- Approximately $3.2 million in non-housing funds would still be available for other non-housing capital needs,
- Agency expenditures to relocate Guadalupe-Auzerais residents could have been reduced significantly, and
- The Agency could have provided for the housing needs of the displaced residents by lending money to developers who would eventually pay the money back to the Agency.

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*Non-housing funds are the 80 percent of the Agency's revenues that are not set aside for low and moderate income housing.

**Agency payments to displaced residents were for rental assistance or assistance to facilitate home purchases.

The Guadalupe-Auzerais Last Resort Housing Plan requires the Redevelopment Agency to provide permanent replacement housing in the Downtown Central Incentive Zone for the displaced residents. Currently, the Agency is making rental assistance payments of $150,000 per year to approximately 40 displaced Guadalupe-Auzerais residents. These payments will continue until permanent housing can be found. Thus, the longer it takes the Agency to provide adequate replacement housing, the longer the Agency will have to make these payments. Accordingly, it is essential that the Agency develop specific plans to provide adequate replacement housing as quickly as possible. Such plans, however, do not exist.

The Guadalupe-Auzerais relocations are not the only relocations that demand adequate Agency planning. Currently, there are at least three other projects that may require the Agency to provide permanent replacement housing to displaced residents. These projects are 1) the Arena project, 2) additional parking for the Convention Center, and 3) the Balbach Street relocation. As mentioned above, 20% Housing funds can be an effective means to reduce the Agency's overall relocation costs while preserving non-housing funds for other capital needs. Therefore, the Agency should begin planning now to meet the housing needs of any residents that may be displaced in those areas. Such planning is especially important because many of the persons who are usually displaced as a result of redevelopment activities fall into the low income category. Finding or developing permanent replacement housing for low income persons or families is especially difficult because of developer reluctance to build low income rental units.

Advantage of the RFP Process

In our opinion, the Agency could better meet the housing needs of displaced residents as well as other low and moderate income persons and families by using a Request for Proposal (RFP) process in addition to its application round process. Such a process requires that the Agency: 1) plan for a specific housing need, 2) evaluate potential sites that meet its locational requirements, 3) buy a site, 4) develop an RFP for the purpose of having some entity develop the site and 5) select an entity to develop the site based on factors such as cost and design.

The RFP process offers several advantages over the Agency's solicitation process. First and foremost, the RFP process requires the Agency to identify a critical housing need and then devise a plan to meet it. Another advantage is that the RFP process provides more competition among developers and non-profit corporations. Such competition should improve the chances that selected housing projects will 1) meet specific housing needs, 2) be the best possible design and 3) be at the lowest possible price. A final advantage of the RFP process is that it allows the Agency to purchase and thus freeze the cost of the land for a project. By so doing, the ultimate cost of the project is reduced.

During our audit, we contacted other California redevelopment agencies that have successfully used the RFP process to develop low and moderate income housing. The Redevelopment Agency, however, has only used the RFP process once. According to the Redevelopment Agency Director, the Agency does not use the RFP process for housing projects because it requires the Agency to purchase land sites. This practice is frequently referred to as "landbanking," and according to the Director, the Board has a policy against it. However, our review of the City's Horizon 2000 Plan and a December 1985 City Council Housing Workshop revealed the following:

- The City's Horizon 2000 Plan provides that:

  "...The City should stimulate the production of low and moderate income housing by appropriately utilizing ...landbanking and such other programs as are authorized by law..."

  "...(20% Housing funds) maybe used for a variety of purposes such as land acquisition..."

  "...The City Administration should study and recommend landbanking of sites of lower-income housing, consistent with the goals and policies of the General Plan and considering a variety of funding sources..."

- The December 1985 City Council Housing Workshop Report contained the following statement regarding the Redevelopment Housing Program:

"...The Redevelopment Agency Board and the City Council may, from time to time, adopt redevelopment plans for designated areas of the City. These plans may identify sites that are suitable for housing use. In order to achieve new housing construction on these sites, the Agency may utilize one or more of the following tools:

1. Purchase and resale of sites to housing developers..."

OPPORTUNITIES TO LEVERAGE HOUSING FUNDS WITH FEDERAL AND STATE FUNDS MAY BE LOST

The Redevelopment Agency needs to improve its planning if it is to take advantage of available Federal and State housing monies that can be used in conjunction with its 20% Housing funds. Although Federal funds are difficult to acquire and State housing monies have been significantly reduced, the Agency can obtain some of these funds if it plans properly. Specifically, there are two existing State and Federal housing programs and one proposed program that are potential sources of funds: 1) Federal Housing Development Action Grants, 2) California Housing Finance Authority Bonds and 3) Federal monies for the homeless.

Housing Development Action Grants

The Department of Housing and Urban Development (HUD) provides Housing Development Action Grants (HODAG's) to support the construction or rehabilitation of residential, rental, cooperative, or shared housing, of which at least 20% will be occupied by low income persons or families. These funds can be used for loans, interest reduction payments, rental assistance, and grants. In 1985-86, HUD had over $72 million to disburse to cities on a competitive basis. The City of Oakland has received over $9 million in HODAG's over the last two years.

HODAG's are difficult to get for two major but not insurmountable reasons. First, before HUD will even consider an application, the applicant must offer proof of site ownership. The other difficulty with securing HODAG's is that HUD only allows three or four weeks between the time it announces that funds will be available and the application deadline. As a result, an applicant must have its project lined up and ready to go well ahead of the application period so that it can react quickly when HUD announces that funds are available. While some private developers are reluctant to participate in projects where site control or funding certainty is a problem, the Agency should begin planning for projects in which it can leverage 20% Housing funds with HODAG grants.

California Housing Finance Agency

The California Housing Finance Agency (CHFA) was initially created in 1976 to issue revenue bonds and make funds available to localities for moderate income, single-family housing. At the time of CHFA's inception, these bonds were very attractive, as most charter cities in the State did not have the authority to issue revenue bonds. In addition, CHFA funds were plentiful and had relatively low interest rates.

Since 1985, the economic situation has changed considerably. Charter cities now have the same bonding authority as the State, and the State has reduced CHFA funding from $10 billion in 1982 to only $1 billion in the current year. As a result, the demand for CHFA monies has decreased significantly. CHFA funds are, however, still used. One recent example is the Agency's Vintage Towers project in which the developer obtained CHFA monies to build low and moderate income housing in the downtown area.

It should be noted that CHFA has survived other periods when funding and developer interest were lacking. Accordingly, CHFA's may rebound again and become a more viable housing resource. The Agency should therefore monitor CHFA's closely and incorporate them into its housing planning process.

Federal Homeless Housing Legislation

A final housing resource area deserving close Agency attention is pending federal legislation to provide housing for homeless persons. This nation-wide problem has emerged on the domestic political forefront and has recently received considerable City attention. The House of Representatives recently passed HR 558, which would provide $725 million in funding for homeless housing. The measure is now pending in the Senate, where it is expected to pass this term. Accordingly, the Agency should be planning appropriate strategies to secure these funds should the legislation be enacted.

In our opinion, an Agency program to aggressively pursue available State and Federal Housing funds would be in consonance with the City Council's December 1985 Housing Workshop Report which identified:

> *"...Creative combinations of both City and Agency housing programs with other resources, such as, State Housing programs..."*

as a "mutually beneficial" linkage between Agency and City programs.

LINKAGES WITH OTHER CITY
DEPARTMENTS MAY BE LACKING

The Agency also needs to improve its planning process for Housing funds in order to more effectively coordinate its activities with the City Department of Neighborhood Preservation. The Agency and the Department both administer housing programs targeting low and moderate income residents. In

1986-87, the Agency provided the Department with $2.3 million in 20% Housing funds for housing rehabilitation programs. The Department also received Federal Community Development Block Grant funds for housing purposes.

City Council Housing Workshop

In December 1985, the City Council convened a Housing Workshop to discuss ways to improve the City's housing programs. The Housing Workshop Report stated in part:

> *"...The City of San Jose and the Redevelopment Agency operate numerous programs designed to provide adequate affordable housing, both generally and to targeted groups. Although significant funds are available for this purpose, the need continues to be greater than the funding base can meet. It is, therefore, critical that the funds available be maximized through formal integration and linkages between the existing programs.*
>
> *Because of the evolutionary nature of the City's and Agency's housing program elements, the process of establishing policies regarding possible integration has not been formally addressed. Linkages between the programs are, however, occurring in several instances. Further, effective linkages have been developed, for instance, between the 20% Housing Program and programs of other agencies, such as the California Housing Agency and the Santa Clara County Housing Authority. These efforts suggest additional possible Agency-City program links..."*

"...The joint approach to housing projects is seen as beneficial in maximizing the utility of the resources available to the City of San Jose. The occurrence of such joint projects could be increased by creating additional linkages between the Agency and City programs. These mutually beneficial linkages include:

- *The City could require that developers utilizing the City's mortgage revenue bond funds also seek Agency 20% Housing Program loan funds for first time homebuyers.*

- *The City could also require that developers receiving residential rental property bond funds a) increase the number and size of units available to low and very low income persons, and b) seek Agency deferred payment loan funding to assure project feasibility under these more stringent requirements.*

- *The Agency and the City could actively explore the possibility of joint publicity programs, requests for proposals, etc. to encourage more developers to effectively combine Agency and City resources.*

- *Applicants could be required to use those City or Agency programs that will provide the best use of funds. For example, Agency 20% Housing Program funds should be used only for projects that cannot obtain mortgage revenue bond funds or can demonstrate that they can produce a lower Agency loan per unit through the use of mortgage revenue bond or comparable funds.*

- *Creative combinations of both City and Agency housing programs with other resources, such as State Housing programs, funds from private foundations, etc. could be encouraged."*

Coordination with the
Department of Neighborhood Preservation

An obvious linkage between the Agency and the City is the Department of Neighborhood Preservation. Both entities share the common goals of improving the City existing housing stock and increasing the supply of low and moderate housing. In addition, opportunities exist for the Agency and Department to establish a joint monitoring program for housing projects (See FINDING IV).

Although the City Council's Housing Workshop was convened in December 1985, the Agency and Neighborhood Preservation have done very little to develop the formal linkages suggested. In the interest of improving the City's overall housing program, the Agency and the Department of Neighborhood Preservation should improve the coordination between their respective housing program. Such improved coordination will not occur, however, without adequate Agency and Department of Neighborhood Preservation planning.

THE HOUSING PROGRAM'S CURRENT ORGANIZATIONAL PLACEMENT AND DEGREE OF TOP MANAGEMENT INVOLVEMENT MAY BE INADEQUATE

The Redevelopment Agency's 20% Housing Program has grown tremendously both monetarily and programatically since 1982. As a result, its current organizational placement and degree of top management involvement may no longer be adequate.

Rapid Growth

The Redevelopment Agency's 20% Housing Program has undergone significant changes in the few years of its existence. Both program funding and focus have increased dramatically.

In 1981, the Agency had approximately $300,000 to spend on housing projects. However, as of 1987, the Agency has committed or spent over $40 million on housing activities. Further, the Agency estimates that it will commit over $70 million in 20% Housing funds for various housing projects over the next five years. Finally, the program has evolved from addressing fairly limited housing needs to a program that has multiple objectives. For example, the City's Downtown Plan cited the need to attract moderate and above-moderate income housing to the downtown. Accordingly, the Agency planned for and used 20% Housing funds to attract this type of housing to the downtown. However, the Agency is now involved in more of the City's overall housing needs. For example, the Agency has received a variety of requests for funding including: 1) housing for the homeless, 2) housing for the developmentally disabled, 3) senior citizen housing, 4) requests to fund the administrative costs of non-profit corporations involved with housing programs and 5) Neighborhood Preservation rehabilitation programs.

In spite of the $12 to $15 million the Housing Program handles each year, it does not have sufficient organizational status. This is evidenced by the fact that 1) only two staff were administering the program until last year, 2) it is a component of an Agency Division, 3) the Housing Program manager does not have direct access to Agency top management, and 4) the Division Chief over the housing component is also responsible for several other large Agency functions, such as site acquisition and relocation. In our opinion, the housing component does not receive sufficient management attention either from within its own division or from the Agency's top management.

In our opinion, the Housing Program's inadequate organizational placement and lack of management attention are symptomatic of the relatively low priority which the Agency has given the 20% Housing Program. This low Agency priority has also manifested itself in a pervasive lack of adequate procedures and controls over other aspects of the Housing Program. These procedural and control deficiencies are discussed in FINDINGS II, III, IV and V.

CONCLUSION

The Agency has not adequately planned for the most effective use of 20% Housing funds. As a result, the housing needs of low or moderate income families may not be met. In addition, with improved planning, opportunities exist to leverage housing funds with Federal and State funds and improve linkages with other City departments. Finally, the organizational location of the Housing Program and the lack of top management attention evidence that the Agency has given the Program a relatively low priority.

RECOMMENDATIONS

We recommend that the Agency:

Recommendation #1:

Develop and implement a formal assessment process to determine the City's low and moderate income housing needs. (Priority 3)

Recommendation #2:

With the assistance of the Agency Board, the Department of Neighborhood Preservation, advocacy groups, developers, and non-profit corporations develop priorities for addressing the City's most critical low and moderate income housing needs. (Priority 3)

Recommendation #3:

Develop one-year and five-year plans and budgets for addressing the City's most critical low and moderate income housing needs. These plans should include:

- Using a Request for Proposal process to meet identified low and moderate income housing needs
- Using 20% Housing funds to provide replacement housing for those residents displaced by redevelopment activities
- Seeking opportunities to leverage 20% Housing funds with available Federal and State funds
- Coordinating with other City departments. (Priority 3)

Recommendation #4:

Assign a higher priority to the 20% Housing Program and elevate it to a higher organizational status within the Agency. (Priority 3)

FINDING II

THE AGENCY NEEDS TO IMPLEMENT ADEQUATE AND SUFFICIENT CONTROLS OVER THE 20% HOUSING LOAN APPROVAL PROCESS

The Redevelopment Agency does not have adequate or sufficient controls over the 20% Housing loan approval process. As a result, the Agency is exposed to the following risks: 1) Funds may not be used effectively to benefit low or moderate income persons or families, 2) uncollectible or undesirable loans may be made, 3) Agency management and Board may lack sufficient information to properly evaluate loan proposals and 4) Agency staff may be inconsistently or unfairly evaluating loan proposals.

Adequate and Sufficient Controls Lacking

The Agency's loan analysis process is one of the most important functions the Housing Program performs. The amount of public funds involved and the impact this process has on the ultimate effectiveness of the entire 20% Housing Program evidence the need for adequate and sufficient controls.

The Agency should have the following controls in place over its 20% Housing loan analysis process: written goals, objectives, plans, budgets, policies and procedures; trained staff; adequate and sufficient forms; and adequate supervision and management information. The following TABLE summarizes 1) the benefits the preceding controls would provide to the Agency, 2) the risks the Agency is exposed to by not having each control in place and 3) whether the Agency has adequately implemented each control.

TABLE III

Comparison of Requisite 20% Housing Loan Analysis Controls, Benefits and Associated Risks Controls to Agency Implemented Controls

Requisite Controls	Control Benefit	Associated Risks of Not Implementing Requisite Controls	Status of Requisite Control Implementation
(1) Written goals and objectives	(1a) Define what the Agency is trying to accomplish	(1a) Agency staff engage in unauthorized activity (1b) Housing resources are illegally or ineffectively used (1c) Agency goals not achieved	Written goals have been established (See Appendix A). However, specific objectives are lacking.
(2) Written plans and budgets	(2a) Define 1) how the Agency plans to meet its overall objectives and 2) management priorities for funding	(2a) Operations not effective or efficient (2b) Agency goals not achieved	Not implemented.
(3) Written policies and procedures	(3a) Provide assurance that Housing proposals are analyzed in accordance with management and Board policies	(3a) Fraud, waste and abuse (3b) Inefficient and ineffective operations (3c) Conflicting policies and procedures (3d) Inconsistent and deficient loan analysis (3e) Policies not followed	Written policies have been adopted. However, written procedures have not been adopted.
(4) A sufficiently trained staff	(4a) Provide assurance that analysis will be competently performed. (4b) Provide assurance that Agency objectives are met in the most efficient manner.	(4a) Resources not used efficiently or effectively (4b) Agency objectives not met (4c) Loan proposals not analyzed consistently or fairly	Some staff lack lending experience and are not receiving formal loan analysis training.

TABLE III (CONT)

Comparison of Requisite 20% Housing Loan Analysis Controls, Benefits and Associated Risks Controls to Agency Implemented Controls

Requisite Controls	Control Benefit	Associated Risks of Not Implementing Requisite Controls	Status of Requisite Control Implementation
(5) Adequate and sufficient forms	(5a) Document the analysis process (5b) Provide guidance to staff during the analysis process (5c) Allow for subsequent supervisory review (5d) Provide an objective basis for evaluating staff performance	(5a) Fraud, waste, and abuse go undetected (5b) Significant errors go undetected (5c) Policies not followed (5d) Agency objectives not met	Forms do not exist to document the loan analysis process.
(6) Adequate supervision	(6a) Provide assurance that staff analyses are consistent, fair and in accordance with Board and management policies	(6a) Same as (5a) through (5d) above	No evidence exists to substantiate supervisory review of loan analysis.
(7) Adequate management information	(7a) Provide assurance to management and the Board that policies and objectives are being met (7b) Allow management and the Board to make informed policy decisions	(7a) Actual operations not in accordance with goals, objectives, or plans (7b) Illegal or improper activities go undetected (7c) Management and the Board make uninformed policy and operational decisions	Per discussion with audit staff, the Agency recently started preparing credit analysis statement for Board review (See page 42).

As the above TABLE demonstrates, the Agency has not implemented adequate or sufficient controls over the loan analysis process. As a result, the Agency is exposed to the following risks:

- Funds may not be used effectively to benefit low and moderate income families or persons,
- Uncollectible or undesirable loans may be made,
- Agency management and the Board may lack sufficient information to intelligently evaluate loan proposals, and
- Agency staff may be inconsistently or unfairly evaluating loan proposals.

FUNDS MAY NOT BE USED EFFECTIVELY TO BENEFIT LOW AND MODERATE INCOME FAMILIES OR PERSONS

Our review identified several projects where 20% Housing funds were not used effectively to benefit low or moderate income persons or families. One such project involved the Agency loaning $1,000,000 to a developer for 84 single family housing units. This loan was designed to reduce the developer's site acquisition costs, thereby allowing the developer to pass on the savings in the form of lower purchase prices to at least 40 persons or families of moderate income. However, of the 75 units that have been sold to date, only 5 have been sold to families meeting the moderate income guidelines. Because only five units have been sold to moderate income buyers, 20% Housing funds were not used efficiently or effectively.

Our review identified two problems with the Agency's analysis of this proposal. First, under terms of the basic agreement the developer had to significantly reduce the price of the housing units in order to keep them affordable to moderate income buyers. Second, even with the discount prices, the housing units were too expensive to be affordable for all but a limited number of moderate income buyers. Specifically, in order to keep the units affordable for moderate income, the Agency required the developer to reduce the purchase price of a unit by as much as $16,000 from its fair market value when it was sold to a moderate income family. As compensation for the lower purchase price, the developer was forgiven approximately $3,000 in interest payments on the $1,000,000 loan for each unit sold to a moderate income family. Thus, the developer realized as much as $13,000 less per unit (the $16,000 purchase price reduction minus the $3,000 interest savings) on units sold to moderate income families.

Further, the Agency's method for determining project affordability needs refinement. In calculating the affordability of proposed for-sale housing units, the Agency staff estimates the annual gross income required to pay for the annual housing costs of the proposed units. These costs are based on the Agency's estimate of the first mortgage costs, property taxes, fire insurance, and other costs associated with owning a home. The Agency then divides the amount of annual housing costs by 33 percent to determine the annual gross income required to pay for the proposed units. The Agency uses this percentage because it assumes that no more than 33 percent of a family's income should be spent on housing costs. If the gross income required is less than 120 percent of the median county income, the Agency considers the proposed units to be affordable to moderate income buyers.

The Agency has used 33 percent of annual gross income as a guideline for determining the affordability of proposed moderate income housing units since the inception of the program. Although this rate may have been valid at one time, it does not appear to be representative of current lending conditions. Specifically, over the last several years, commercial lenders have tightened home mortgage qualification requirements. During this time, commercial lenders have been using a more restrictive guideline of 25 to 28 percent of annual gross income to qualify buyers for home mortgages. Application of this guideline results in an increase in the buyer's annual gross income requirement to qualify for the loan. Therefore, by using a less restrictive guideline, the Agency may determine erroneously that proposed units are affordable to moderate income buyers, when in fact, prospective buyers approved by the Agency may not qualify for first mortgage loans.

According to Agency officials, when they analyzed this project, they concluded that the project, while expensive, would be affordable to moderate income buyers. In addition, according to Agency staff, they wanted to pursue the project because it was a high-quality, single-family housing project. However, in our opinion, because only five units were sold to moderate income buyers, 20% Housing funds were not used effectively in this case.

The Agency also loaned $500,000 to a developer for a portion of the permanent financing on an apartment complex. The terms of the agreement were as follows: 1) the loan is for 24 years, 2) no interest is to be charged for the first four years, 3) a four percent interest rate is to be charged over the remainder of the loan and 4) the developer is to apply 50% of annual net cash flows toward the loan.

In return for the use of the $500,000, the Agency only required the developer to keep 71 of the 142 rental units *affordable* to persons or families of moderate income. It should be noted that the Agency did not *require* the developer to rent units to low or moderate income residents or charge below-market rents. Further, based on the Agency's income guidelines, the developer could charge market or higher rents for the units and they would still be under the moderate income guidelines. For example, for a family of two, the developer could charge over $1,000 (including utilities) per month for a two-bedroom apartment unit and still be 1) under the moderate income guidelines and 2) above the market rate for this type of housing unit.

Further, our analysis revealed that the developer's rate of return on this project appears to be high. Specifically, based on Agency data, we calculated that the developer's rate of return on this project was over 20 percent. According to Agency officials, this is a high rate of return for this type of project.

In our opinion, had Agency staff adequately analyzed the developer's rate of return for this project, the Agency could have reduced its contribution on the project or negotiated more favorable rents for low or moderate income families.

According to Agency officials, the program did not have adequate staffing to analyze developer rates of return for all housing proposals. In our opinion, the Agency should be consistently using various financial analysis techniques when evaluating housing proposals. These techniques, which are applicable for different types of housing proposals, include the "internal rate of return" which measures the yield on investments and "net present value," which is another technique that measures the economics of the project. By consistently using the applicable technique, the Agency can better determine the appropriate level of funding, that is, the level where the developer realizes a reasonable profit and low and moderate income persons receive maximum benefits. This is especially important now as the requests for 20% Housing funds exceed available funds. Reducing the loan amounts on some projects would allow the Agency to fund more projects and provide additional low and moderate income housing for the same amount of money.

UNCOLLECTIBLE OR
UNDESIRABLE LOANS MAY BE MADE

Our review also revealed instances where the Agency has not always followed established lending practices that are designed to reduce the risks of issuing uncollectible or undesirable loans. Specifically, we found that the Agency 1) loaned money without an independent appraisal, 2) did not comply with its own lending policies, 3) loaned money without obtaining a credit history on the borrower and 4) loaned money without adequate or complete information.

Loaned Money Without Getting
An Independent Appraisal

Before lending money for the purchase of any real property, any lending institution should obtain an independent appraisal from a qualified appraiser. The independent appraisal is a necessary control to ensure that the property held for collateral provides the lender with sufficient protection in the event the borrower defaults on the loan. In order to qualify as an independent appraisal, two qualitative elements are essential; the appraiser must be a professional and not affiliated with the borrower.

During our review, we identified a project for which the Agency did not get an independent appraisal. In this instance, the Agency loaned $420,000 to a non-profit corporation to purchase a parcel of property. Instead of getting an independent appraisal to estimate the value of the property, the Agency relied on an appraisal that a member of the non-profit corporation's Board of Directors performed. Because the appraiser was by definition not independent, the appraisal is of questionable validity and the Agency is at risk should the borrower default on the loan.

Not Complying with Its Own Policy

The Agency's lending policy is to not lend more than 90 percent of the appraised value of real property. This policy is designed to protect the Agency in the event the borrower defaults on a loan. Theoretically, the Agency should be able to recoup the full amount of its loan because the property is worth more than the amount loaned.

Our review, however, identified a project in which the Agency loaned approximately $60,000 more than its own policy prescribes. In this instance, the appraised value of the subject property was $585,000. The Agency loaned $240,000 on a second mortgage to purchase two older structures which were the collateral for the loan. In addition, there was a first mortgage against the property of $346,000. Thus, the total indebtedness against the subject property was $586,000 or $1,000 more than 100% of its appraised value. Had the Agency complied with its own policies, the combined total of first and second mortgages should not have exceeded $526,500. Thus, the Agency exceeded its own lending limit by $59,500.

It should be noted that because the Agency is the second mortgage holder, it is in a more vulnerable position than the first mortgage holder should the borrower default on the loan. In that event, the first mortgage holder would 1) institute foreclosure proceedings and 2) receive first consideration for any sales proceeds. The Agency would be entitled to only the residual sales proceeds over and above the amount of the first mortgage.

It should also be noted that for this project, the borrower was to use the funds to purchase and rehabilitate two older structures for the purpose of providing low income housing. The funding for the project was in two phases. The first funding phase was $240,000 for the purchase of the property and the structures. The second funding phase was $110,000 for the rehabilitation of the structures. The loan agreement required the developer to acquire the property and commence rehabilitation within 60 days of the execution of the agreement. However, as of February 1987, the developer had not commenced the required rehabilitation work in spite of the fact that the agreement was executed in September 1986.

Did Not Obtain Credit Histories On Borrowers

A credit history is a necessary lending control to ensure that borrowers have good credit histories and are financially stable. However, until this year, the Agency did not routinely obtain credit histories on borrowers. Instead, it relied on other lenders to perform this function. As a result, the Agency did not obtain sufficient information to evaluate the credit worthiness of borrowers. One consequence of this practice was that the Agency approved a loan for a developer that was in bankruptcy.

The Agency has taken corrective action to remedy this problem. Specifically, the Agency now requires all 20% Housing loan applicants to submit credit information and performs credit checks on those applicants.

Did Not Have Adequate
or Accurate Information

Detailed plans for construction projects provide a control to minimize the risk of cost overruns to lenders. Based on detailed plans, a lender can develop reasonable estimates of project costs. These estimates provide lenders assurance that the actual cost of the project will not greatly exceed its estimated cost. Thus, detailed plans reduce the risk of cost overruns that could either halt projects or eventually require additional funding.

Our review, however, revealed instances where the Agency has funded projects without the benefit of cost estimates based on detailed plans. For example, the Agency loaned money to a developer to purchase an older housing structure and made a loan commitment to the same developer to rehabilitate the structure. However, the Agency made the loan commitment without having cost estimates that were based on sufficiently detailed plans. As a result, the Agency is at risk that it funded a project that will not be completed, or it may have to lend additional funds in order to finish the project.

AGENCY MANAGEMENT AND THE BOARD MAY LACK SUFFICIENT INFORMATION TO <u>PROPERLY EVALUATE LOAN PROPOSALS</u>

An effective control procedure to ensure that staff has complied with the Agency's lending policies and procedures is a credit analysis statement. Lending institutions use credit analysis statements as a management control to 1) ensure that lending staff are complying with established policies and procedures and 2) provide necessary information for loan committees to review when approving or denying loan requests. Specifically, a credit analysis statement includes, but is not limited to, the following information:

- Name of the developer or borrower
- Short description of the proposed project
- Past projects of the developer
- Loan amount requested
- Appraised value of the property
- Advance rate
- Appraiser
- Credit history
- Proposed loan terms
- Staff recommendations

The Agency has not used credit analysis statements to provide additional information to Agency management and to the Agency Board on projects that are to be funded. Instead, the Agency has provided a narrative description for each project for which it recommended funding. This narrative, however, does not provide information on the loan advance rate, even though it is the Agency's policy not to advance more than 90 percent of the appraised value of the property. Without this information, the Agency's management and the Agency Board do not have adequate information to determine if the Agency is complying with its policy. In addition, the narrative does not provide specific information on loan terms and the credit history of the developer or borrower. As a result, the Agency Board does not have sufficient information with which to review and subsequently approve or deny the loan requests.

During the course of our audit, we recommended to Agency staff that they prepare credit analysis statements for Board use when Housing proposals are submitted for approval. As a result, Agency staff did submit a form which incorporated some of the elements of a credit analysis statement for Housing Program applicants at the Board's May 7, 1987, meeting. Several Board members have indicated that they found the additional information useful.

AGENCY STAFF MAY BE INCONSISTENTLY OR UNFAIRLY EVALUATING LOAN PROPOSALS

Our review also identified that the Agency does not adequately document its loan analysis process. Adequate documentation for this process is an important Agency control to minimize the risk of its staff analyzing loan proposals inconsistently or unfairly. Key control techniques for documenting the loan analysis process are: 1) written procedures that specifically define how staff should analyze housing proposals, 2) necessary forms to document what analysis staff did perform, 3) necessary forms to establish staff accountability for analyzing loan proposals and subsequently reviewing the loan analysis, 4) adequate and consistent recordkeeping systems that allow for easy review of staff analyses and 5) adequate and sufficiently documented supervisory review. When these controls are in place, the Agency can be reasonably assured that loan proposals have been analyzed consistently and fairly.

Our review found that the Agency has not implemented the above key control techniques. Further, the Agency cannot be assured that staff analyzed each loan proposal for the following attributes:

- Does the project meet the Agency's priorities for funding?
- Are the costs of proposed project reasonable?
- Does the project maximize the benefits to low and moderate income residents?
- What is the developer's return or profit on the project?
- Will the proposed housing units be affordable to low or moderate income families?
- Does the project constitute an optimal use of 20% Housing funds?

Without these controls in place, the Agency is at risk from employees inconsistently or unfairly analyzing loan proposals. The fact that few staff are involved in analyzing loan proposals and that their work influences how large sums of public monies will be spent increases the need for adequate loan analysis controls.

CONCLUSION

The Redevelopment Agency has not developed adequate controls over its loan approval process. As a result, the Agency is exposed to the following risks: 1) 20% Housing funds are not being used effectively, 2) undesirable loans may be made, 3) Agency and Board policies may not be followed and 4) staff may not analyze housing proposals thoroughly, consistently or fairly.

RECOMMENDATIONS

We recommend that the Agency:

Recommendation #5:

Develop written procedures for analyzing and approving loan proposals. These procedures should ensure that loan proposals are analyzed consistently and fairly and that 20% Housing funds are used effectively. (Priority 2)

Recommendation #6:

Provide training to staff on procedures for analyzing and approving housing proposals. (Priority 2)

Recommendation #7:

Periodically review the guidelines that commercial lenders use to qualify buyers for home mortgages. Based on this information, adjust its own guidelines for determining the affordability of proposed housing units to moderate income buyers. (Priority 2)

Recommendation #8:

Develop necessary forms for analyzing and approving loan proposals. These forms should adequately document the loan analysis process and facilitate supervisory review. (Priority 2)

Recommendation #9:

Assign responsibility for preparing and reviewing the loan analysis as a means of establishing accountability over the loan analysis process and subsequent supervisory review. (Priority 2)

Recommendation #10:

Develop and use a Credit Analysis Statement to convey important loan proposal information to Agency management and the Board. (Priority 3)

FINDING III

THE REDEVELOPMENT AGENCY NEEDS TO IMPLEMENT ADEQUATE AND SUFFICIENT CONTROLS TO ENSURE THAT LOAN DOCUMENTS ARE PROPERLY PREPARED

The Redevelopment Agency has not implemented adequate or sufficient controls to ensure that all necessary loan documents are completed and properly prepared prior to executing agreements. As a result, the Agency is exposed to the following risks: 1) loans may be invalidated because of significant errors on loan documents, 2) the Agency may not be complying with Federal and State lending laws and 3) some of the Agency's loans may not be enforceable.

Need for Adequate and Sufficient Controls

Loan documents such as promissory notes, deeds of trust, and loan agreements are the Agency's evidence of the terms and conditions of their loans. In some instances, these documents must be presented in court to substantiate the terms of Agency's loans. Therefore, the Agency must have adequate controls in place to ensure that loan documents are properly prepared.

The Agency should have the following controls in place over its 20% Housing loan document preparation process: written procedures for preparing, reviewing, and approving loan documents; comprehensive checklists; and adequate and sufficient forms. The following Table summarizes 1) the benefits the preceding controls would provide to the Agency, 2) the risks the Agency is exposed to by not having each control in place and 3) whether the Agency has adequately implemented each control.

TABLE IV

Comparison of Requisite Document Processing Controls, Benefits and Associated Risks to Agency Implemented Controls

Requisite Controls	Control Benefit	Associated Risks of Not Implementing Requisite Controls	Status of Requisite Control Implementation
(1) Written procedures for preparing, reviewing, and approving loan documents	(1a) Provide assurance that documents are complete and error free	(1a) Loan packages incomplete or contain errors	Not implemented.
	(1b) Provide assurance that loans are in accordance with Board policies and State and and Federal laws	(1b) loans unenforceable	
		(1c) Agency subject to legal actions	
		(1d) Agency objectives not met	
(2) Comprehensive loan file checklists	(2a) Provide assurance that all documents are completed and properly filed	(2a) Documents not completed	Per discussions with audit staff, the Agency recently developed loan file checklists.
		(2b) Loans unenforceable	
(3) Adequate and sufficient forms	(3a) Establish accountability for preparing, reviewing, and approving important documents	(3a) Significant errors go undetected	Not implemented.
	(3b) Facilitate supervisory review	(3b) Fraud, waste and abuse go undetected	

As the above TABLE demonstrates, the Agency has not implemented adequate or sufficient controls over its 20% Housing loan preparation process. As a result, the Agency is exposed to the following risks:

- Loans could be invalidated because of significant errors on loan documents,
- The Agency is not complying with Federal and State lending laws, and
- Some of the Agency's loans may not be enforceable.

LOANS COULD BE INVALIDATED BECAUSE OF SIGNIFICANT ERRORS ON LOAN DOCUMENTS

The Agency has made significant errors or omissions on loan documents that were not detected. Consequently, several Agency loans may not be legally enforceable. For example, the County recorded an Agency second mortgage loan for $19,000 without the amount of the loan on the recorded deed of trust. In another instance, the Agency improperly amended a promissory note from $400,000 to $470,200. Specifically, a staff member crossed out the numerical value of the original loan and wrote in the amount of the new loan. The staff person, however, did not change the written amount of the old loan on the note. Finally, the Agency omitted the "additional charge" provisions on three promissory notes for second mortgage loans to homebuyers. The Agency intended to require the homeowners to pay an additional charge if the units were sold to buyers that did not meet the moderate income housing guidelines. The purpose of this charge was to prevent the homeowners from profiting from the sale of the subsidized housing unit. However, Agency staff omitted the amount of the additional charges on the promissory notes and did not detect the omissions. As a result of the above errors or omissions, the Agency may be unable to enforce the terms of those loans.

THE AGENCY COULD BE SUBJECT TO LEGAL DAMAGES BECAUSE OF NONCOMPLIANCE WITH FEDERAL AND STATE LENDING LAWS

The Redevelopment Agency, as a lending institution, is subject to Federal Truth-In-Lending laws and California Fair Lending laws. Section 121 of the Truth-In-Lending Act, Title 15, *United States Code*, Section 12, 226, *et. seq.*, requires lending institutions to disclose the following information to borrowers: 1) the stated amount of interest rate on a loan, 2) the effective interest rate on a loan, 3) the term of the loan, and 4) the total finance charges over the term of the loan. The Act applies primarily to consumer loans, which the Agency's second mortgage loans are considered to be.

California Health and Safety Code Section 35800, *et. seq.*, requires financial institutions to notify all loan applicants, at the time they apply, that financial institutions cannot discriminate against any applicants because of race, color, religion, sex, marital status, national origin, or ancestry. The Act also requires financial institutions to notify applicants that a complaint can be filed if a violation of the discrimination laws is alleged. Compliance with this Act is especially important when the Agency denies a loan request because the denied applicants may allege discrimination.

Our audit revealed that the Agency has not complied with the disclosure requirements of either the Federal Truth-In-Lending law or the California Fair Lending law. According to Agency officials, they have not complied with these laws because they were not aware that the Agency was subject to their requirements. Furthermore, the California Fair Lending law specifies that in instances of noncompliance, financial institutions may be required to either make the denied loan or pay damages up to $1,000. The Agency has denied five second mortgage loans but did not notify the applicants of their right to file a complaint.

SOME OF THE AGENCY'S LOANS MAY NOT BE ENFORCEABLE

When lending money to corporations, lending institutions require borrowers to submit documentation that the borrower is authorized to borrow for the corporation. This documentation, known as a *"Corporate Resolution to Borrow,"* is a control to prevent unauthorized persons from borrowing in the name of the corporation.

Our audit revealed that the Agency does not follow this lending practice. Although the Agency lends money to corporations, both private and non-profit, it does not require borrowers to submit a Corporate Resolution to Borrow. As a result, the Agency has no assurance that these borrowers have been properly authorized to borrow in the name of their corporations. Consequently, the Agency is exposed to the risk of making unenforceable loans.

CONCLUSION

The Redevelopment Agency has not implemented adequate controls to ensure that all necessary loan documents are completed prior to executing loan agreements. Furthermore, the Agency has not complied with Federal and State Lending Laws and applicable sound lending practices.

RECOMMENDATIONS

We recommended that the Agency:

Recommendation #11:

Develop and implement written procedures for preparing, reviewing, and approving loan documents. (Priority 2)

Recommendation #12:

Formally assign responsibility for preparing, reviewing and approving loan documents. (Priority 2)

Recommendation #13:

Develop and consistently use checklists for ensuring that necessary loan documents are properly prepared. (Priority 2)

Recommendation #14:

Develop and use forms for establishing accountability for the preparation, review, and approval of loan documents. (Priority 2)

Recommendation #15:

Develop and use written procedures and necessary forms to comply with the Federal Truth-In-Lending Law and the California Fair Lending law. (Priority 1)

Recommendation #16:

Develop and use written procedures and necessary forms to ensure that corporate borrowers are properly authorized to borrow in the name of their corporation. (Priority 2)

FINDING IV

THE HOUSING PROGRAM NEEDS TO IMPLEMENT A MONITORING PROGRAM

The Housing Program is not monitoring borrowers to ensure that they are complying with all the terms of their loan agreements. As a result, the Agency is exposed to the following risks: 1) borrowers may not be in compliance with their loan agreements, 2) 20% Housing funds may not be used as intended, and 3) loans may not be insured against fire losses.

Monitoring Program Lacking

The Agency includes many performance requirements in its loan agreements to ensure that 20% Housing funds are used as intended and units built with 20% Housing funds are adequately protected. Examples of common performance requirements included in the Agency's loan agreements are:

1. Developers are required to set aside a specific number of rental units at a specified rental rate.
2. Developers are required to keep a specific number of rental units affordable to families of low and moderate income.
3. Developers are required to submit an annual statement of rents.
4. Developers are required to submit an annual financial statement on the net income of the development.
5. Borrowers are required to provide proof of insurance coverage on subsidized units.

The Housing Program should have the following monitoring controls in place: written policies and procedures, written site visit schedules, adequate and sufficient forms, tickler files, adequate supervision, and adequate management information.

The following Table summarizes 1) the benefits the preceding controls would provide to the Agency, 2) the risks the Agency is exposed to by not having each control in place, and 3) whether the Agency has adequately implemented each control.

TABLE V

Comparison of Requisite Monitoring Program Controls, Benefits and Associated Risks To to Agency Implemented Controls

Requisite Controls	Control Benefit	Associated Risks of Not Implementing Requisite Controls	Status of Requisite Control Implementation
(1) Written policies and procedures	(1a) Provide assurance that Agency goals are met and 2) staff perform in accordance with Board Policies	(1a) Inefficient and ineffective operations (1b) Conflicting policies and procedures (1c) Inconsistent or nonexistent monitoring (1d) Agency goals not met (1e) Board policies not followed	Agency is developing written policies and procedures.
(2) Written Site Visit Schedules	(2a) Provide for proper timing of monitoring visits	(2a) Duplicative and wasteful use of resources	Not implemented.
(3) Adequate and sufficient forms	(3a) Establish accountability for monitoring borrowers (3b) Facilitate supervisory review	(3a) Inconsistent or non-existent monitoring (3b) Agency goals not met (3c) Board policies not met	Not implemented
(4) Tickler files	(4a) Remind staff of when loan conditions should be satisfied	(4a) Inconsistent or non-existent monitoring (4b) Loan safety jeopardized (4c) Borrower noncompliances with loan agreements	Not implemented
(5) Adequate supervision	(5a) Provide assurance that staff are fulfilling their monitoring responsibilities	(5a) Inefficient and ineffective operations	Not applicable because Housing staff are not monitoring projects

TABLE V (CONT)

Comparison of Requisite Monitoring Program Controls, Benefits and Associated Risks To to Agency Implemented Controls

Requisite Controls	Control Benefit	Associated Risks of Not Implementing Requisite Controls	Status of Requisite Control Implementation
		(5b) Inconsistent or non-existent monitoring	
		(5c) Agency goals not met	
		(5d) Board policies not followed	
(6) Adequate management information	(6a) Provide assurance to management and the Board that policies and objectives are being met	(6a) Agency goals not met	Not implemented.
	(6b) Facilitate appropriate policy revisions	(6b) Appropriate policy changes not made	

As TABLE V demonstrates, the Housing Program has not implemented a monitoring program. As a result, the Agency is exposed to the following risks:

- Borrowers may not be in compliance with their loan agreements,
- 20% Housing funds may not be used as intended, and
- Loans may not be insured against fire losses

BORROWERS MAY NOT BE IN COMPLIANCE WITH THEIR LOAN AGREEMENTS

Without adequate monitoring, the Housing Program cannot be assured that borrowers are in compliance with the terms of their loan agreements or that developers are building housing units that are affordable to low and moderate income persons and families. For example, one loan agreement requires the developer to make 38 units affordable to persons of low income. Another agreement requires the developer to set aside 52 rental units for persons of low income. Both of these developments have been completed, but the Agency has not monitored either of them to ensure that the developers are complying with the terms of their loan agreements.

Thus far, the Housing Program has not monitored any of the 11 developments for which it has loaned $4,153,878 to create 811 low and moderate rental units.

20% HOUSING FUNDS MAY
NOT BE USED AS INTENDED

The Housing Program is also not monitoring homeowners to ensure that they are residing in the housing unit which the Agency assisted them in purchasing. In its second mortgage loans to homeowners, the Agency can penalize buyers if they rent their units for more than four months out of the year. This practice is designed to ensure that units are actually used for low or moderate income housing. However, the Agency does not monitor these owners to ensure that they are not renting out their units. Consequently, the Agency has no assurance that these borrowers are complying with the terms of their loan agreements.

An efficient way to monitor homeowners' use of their property would be for the Agency to send a certified letter to these residences on an annual basis. This procedure could provide some assurance that homeowners are not renting out their units. In those instances when a certified letter is returned as being undeliverable, the Housing Program could perform additional follow-up work to ensure that the owners are actually occupying their units.

LOANS MAY NOT BE INSURED AGAINST FIRE LOSSES

The Housing Program also has not monitored borrowers to ensure that housing units in which the Agency has an ownership interest are adequately insured. Loan agreements require borrowers to provide proof of fire insurance coverage as a control that the housing units are adequately insured from loss due to fire. However, our review revealed that the Agency was lacking the required proof of insurance for 6 out of 9 rental developments and 10 of 11 second mortgage loans. Consequently, the Agency has no assurance that housing units in which it has an ownership interest are adequately insured from loss due to fire.

It should be noted that the Agency's Project Management Division does monitor housing projects for construction progress. It should also be noted that the Housing Program has taken some corrective action to establish a monitoring program. Specifically, a staff person has been hired to monitor borrowers and develop monitoring procedures.

CONCLUSION

The Housing Program has not developed a monitoring program to ensure that borrowers are complying with the terms of their loan agreements. As a result, the Agency has no assurance that 20% Housing funds are being used as intended and housing units are adequately insured against fire losses.

RECOMMENDATIONS

We recommend that the Agency:

Recommendation #17:

Develop and implement written policies and procedures for monitoring borrowers. (Priority 2)

Recommendation #18:

Develop schedules for monitoring borrowers. (Priority 3)

Recommendation #19:

Develop and implement reporting forms for communicating the results of its monitoring visits. (Priority 3)

Recommendation #20:

Develop and implement tickler files to remind staff when to monitor borrowers. (Priority 2)

Recommendation #21:

Develop and implement a management information system to provide feedback on monitoring accomplishments. (Priority 3)

FINDING V

THE AGENCY NEEDS TO IMPLEMENT ADEQUATE AND SUFFICIENT ACCOUNTING CONTROLS TO SAFEGUARD ITS ASSETS AND PREVENT ERRORS

The Redevelopment Agency has not implemented adequate or sufficient accounting controls over its 20% Housing Program. As a result, the Agency is exposed to the following risks: 1) staff may engage in improper activities without being detected, 2) financial records may be materially inaccurate, and 3) important loan documents may not be adequately safeguarded.

Need for Accounting Controls

Accounting controls are those procedures and techniques that are imposed on an accounting system to prevent, detect, and correct errors and irregularities. The overall objective of these controls is to safeguard assets and enhance the reliability of the financial statements. The Agency should have the following appropriate key accounting controls in place: segregation of functional responsibilities; written policies and procedures; trained staff; adequate supervision; limited access to important documents; periodic reconciliations of general ledger accounts to subsidiary accounts, and periodic verification of the existence of assets or documents. The following Table summarizes 1) the benefits each of the above controls would provide to the Agency, 2) the risks the Agency is exposed to by not having each control in place and 3) whether the Agency has adequately implemented each control.

TABLE VI

Comparison of Requisite 20% Housing Accounting Controls, Benefits, and Associated Risks to Agency Implemented Controls

Requisite Controls	Control Benefit	Associated Risks of Not Implementing Requisite Controls	Status of Requisite Control Implementation
(1) Segregation of functional responsibilities	(1a) Provide assurance that activities are carried out properly (1b) Protect assets from misappropriation, pilferage and other inappropriate activities (1c) Provide assurance that Housing activities are properly recorded	(1a) Fraud, waste and abuse (1b) Illegal or improper activities (1c) Assets susceptible to misappropriation, pilferage and other inappropriate activities (1d) Inaccurate and misstated accounting records	Partially implemented.
(2) Written policies and procedures	(2a) Provide assurance the Agency assets are protected (2b) Provide assurance that Housing activities are properly recorded	(2a) Assets susceptible to misappropriation, pilferage and other inappropriate activities (2b) Inaccurate and misstated accounting records	Not implemented.
(3) Trained staff	(3a) Provide assurance that Housing activities are properly recorded	(3a) Inaccurate and misstated accounting records	General lack of accounting and control expertise
(4) Adequate supervision	(4a) Provide assurance that Housing activities are properly recorded	(4a) Inaccurate and misstated accounting records	Not implemented.
(5) Limited access to important documents	(5a) Protect assets from misappropriation, pilferage and other inappropriate activities	(5a) Assets susceptible to misappropriation, pilferage and other inappropriate activities	Partially implemented.

TABLE VI (CONT)

Comparison of Requisite 20% Housing Accounting Controls, Benefits, and Associated Risks to Agency Implemented Controls

Requisite Controls	Control Benefit	Associated Risks of Not Implementing Requisite Controls	Status of Requisite Control Implementation
(6) Periodic reconciliations of general ledger accounts to subsidiary accounts	(6a) Provide assurance that Housing activities are properly recorded	(6a) Inaccurate and misstated accounting records	Not implemented.
		(6b) Illegal or improper activities go undetected	
(7) Periodic verification of the existence of assets or documents	(7a) Protect assets from misappropriation, pilferage and other inappropriate activities	(7a) Assets susceptible to misappropriation, pilferage and other inappropriate activities	Not implemented.
	(7b) Provide assurance that Housing activities are properly recorded	(7b) Inaccurate and misstated accounting records	
		(7c) Illegal or improper activities go undetected	

As TABLE VI demonstrates, the Agency has not implemented adequate or sufficient accounting controls over the 20% Housing Program. As a result, the Agency is exposed to the following risks:

- Staff may engage in improper activities without being detected,
- Financial records may be materially inaccurate, and
- Important loan documents may not be adequately safeguarded

STAFF MAY ENGAGE IN IMPROPER ACTIVITIES WITHOUT BEING DETECTED

According to auditing standards, incompatible functions occur when a person is in a position to perpetrate and conceal errors and irregularities in his or her normal job. An essential control to prevent incompatible functions is segregation of duties and functional responsibilities which ensure that one department, or at least different persons within a department, are not performing more than one of the following functions: 1) authorizing transactions, 2) recording transactions, 3) maintaining custody of assets involved in the transaction and 4) reconciling the existing assets to the accounting records.

However, our review revealed instances where staff in the Agency's Housing Program are performing all of the following incompatible functions:

- Approving loans
- Authorizing payment of Housing funds to borrowers
- Maintaining custody of loan documents
- Maintaining loan subsidiary ledgers
- Calculating interest payments on loans, and
- Receiving payments on loans

For example, we identified one instance where the Agency had deposited approximately $1,300,000 into escrow for a development. This money was to be used for second mortgages for moderate income persons or families. Over the course of one year, Housing staff 1) reviewed and approved loan applications, 2) approved payments out of the escrow account for second mortgages, 3) prepared and maintained the subsidiary accounts for these loans, 4) maintained custody of loan documents, 5) received statements from the bank on the status of the $1,300,000 placed in escrow and 6) were responsible for transmitting loan details and payment and escrow information to the Agency's Fiscal and Administrative Services Division.

In addition, our review revealed that when early loan payoffs were made on second mortgages, Housing staff; 1) calculated the amount of the payment due, 2) calculated the interest portion of the payment and 3) were the initial Agency recipient of the payments.

It should be noted that when the Agency issues a second mortgage, no payments are made against the loan until it is fully paid at the end of seven years, unless the borrower chooses to pay the loan sooner. This situation increases the risk that staff could misuse earlier payments on second mortgages without detection because such payments are not expected.

In our opinion, the Agency's procedures for handling second mortgage loans violate the most basic segregation of functional responsibilities principles. Accordingly, the Agency's exposure to risk in this area is significant. Further, such exposure is exacerbated by the fact that 1) the circumstances described above are typical and pervasive for the Agency's second mortgage program and 2) as of March, 1987, the Agency had used more than $3 million in Housing funds for second mortgages. Finally, the Agency's practice of placing Housing funds in escrow accounts for long periods of time is inappropriate for two reasons. First, the Agency loses fiscal control over the funds it originally deposited plus any interest earned on these deposits until the escrow is closed. Secondly, the interest earnings on these escrow accounts are usually less than what the Agency could earn through its own investment program.

FINANCIAL RECORDS MAY BE MATERIALLY INACCURATE

Proper accounting controls require that accounting staff reconcile the general ledger with subsidiary ledgers on a regular basis. This control procedure helps to ensure that all transactions are recorded properly and that accounts are properly stated. When unreconciled differences exist between the general ledger and secondary ledgers, there is potential that transactions have been improperly recorded or not recorded at all. Accordingly, appropriate follow-up and corrective action should be taken for such differences.

Our audit found that the Agency has not developed procedures to reconcile its general ledger Loans Receivable Accounts and its subsidiary accounts. In fact, the Agency's general ledger accounts and subsidiary ledgers do not agree. For instance, the general ledger and the subsidiary ledger for one housing project were off by approximately $600,000. This lack of accounting control increases the risk that loans and loan repayments have not been properly recorded.

In addition, we noted that other major accounting controls were lacking in the areas of calculating interest payments, crediting borrower's accounts for loan repayments and accounting for loans.

Interest Payments are Not Consistently Calculated

Although few Agency loans have been repaid, we tested several loan repayments to determine if the Agency calculated them properly. For one development we tested three repayments on second mortgage loans and found that all three of the loan repayments were calculated differently. For one repayment, the Agency calculated the repayment by multiplying the principal times the stated interest rate, assuming a 365 day year. On another repayment, the Agency calculated the repayment by multiplying the principal times the stated interest rate assuming a 360 day year. Finally, on the third repayment, the Agency calculated the repayment by multiplying the principal plus the annual accrued interest times the stated interest rate assuming a 365 day year.

Loan Repayments Are Not Being Properly Credited to a Borrower's Account

Our review also revealed an instance where the Agency is not properly crediting loan repayments to a borrower's account. As a result, the Agency is overcharging the borrower.

In this case, the Agency prepared an amortization schedule for the borrower to repay the loan. The overcharge resulted when the borrower paid more than was specified on the amortization schedule, and the Agency continued to charge the same interest specified on the amortization schedule. Since the borrower is making accelerated payments against the loan, the Agency should be applying less of the payments to interest and crediting more to the borrower's principal amount.

Improper Accounting for Loans

Proper accounting procedures require that individual loans be accounted for separately. Since each loan is a separate transaction with different loan amounts, due dates, and payment requirements, separate accounting treatment is essential. Such treatment helps assure proper recordation, equity to both the lender and borrower and facilitates reliable management information.

During our audit we noted that the Agency is not accounting for loans separately. Specifically, the Agency is combining several loans on one account. For example, the Agency loaned money to a developer to construct condominiums. When the developer completed the condominiums, the Agency allowed the developer's repayments on the construction loan to be used to provide second mortgage loans to homebuyers. Instead of maintaining separate loan records for 1) the construction loan and 2) each second mortgage loan, the Agency is accounting for all of the loans like they were one. As a result, the Agency cannot readily determine the current status of each loan and will not know how to properly record subsequent loan or payment transactions.

We also noted another instance where the Agency is accounting for two separate loans with a non-profit corporation like they were one, even though they are for different amounts and have different payment requirements. Accordingly, separate accounting for these loans is required in order to maintain record integrity and to protect the interest of the Agency and the borrower.

IMPORTANT LOAN DOCUMENTS MAY NOT BE ADEQUATELY SAFEGUARDED

Assets and important loan documents such as promissory notes, deeds of trust, and loan agreements should be properly safeguarded to prevent them from being lost, misplaced, or stolen. These documents are the Agency's means of verifying the terms of their loans. If these documents were lost, the Agency may not have adequate evidence to legally enforce all the terms of their loan agreements.

The Agency has not implemented adequate or sufficient controls for maintaining custody of promissory notes, loan agreements, and deeds of trust. Specifically, we found 27 promissory notes totaling $16 million that were left in unlocked cabinets. Further, no one person in the Agency was assigned the responsibility for maintaining custody of these important documents. Consequently, the Agency is exposed to the risk that these documents may be lost, destroyed or stolen.

It should be noted that during the course of our audit we advised the Agency of this situation and it took corrective action. The Agency now locks promissory notes for developments and second mortgage loans in fire-proof cabinets. However, the Agency still does not lock all of its original legal documents in fire-proof cabinets. Further, the Agency has not established formal controls for maintaining custody of important documents.

CONCLUSION

The Redevelopment Agency has not implemented adequate fiscal or accounting controls over the 20% Housing Program. Specifically, we found that the Agency has not adequately segregated significant accounting functions, reconciled accounting records, calculated interest payments, accounted for loans and interest earnings, or safeguarded important documents.

RECOMMENDATIONS

We recommend that the Agency:

Recommendation #22:

Develop an organization plan which adequately segregates functional responsibilities. (Priority 1)

Recommendation #23:

Develop written policies and procedures for all of its accounting activities including the following:

- Maintaining custody of assets and important legal documents
- Reconciling general ledger accounts and subsidiary ledgers on a regular basis
- Reconciling records to actual assets on a regular basis
- Calculating interest payments
- Applying repayments to loan accounts
- Accounting for loans (Priority 1)

Recommendation #24:

Develop necessary forms and procedures to ensure that all work is adequately documented and subsequently reviewed. (Priority 1)

Recommendation #25:

Provide ongoing training to staff on policies and procedures. (Priority 2)

Recommendation #26:

Discontinue the practice of placing money for second mortgages in escrow accounts. (Priority 1)

THE REDEVELOPMENT AGENCY OF THE CITY OF SAN JOSE

MEMORANDUM

TO: GERALD A. SILVA CITY AUDITOR	FROM: FRANK M. TAYLOR EXECUTIVE DIRECTOR
SUBJECT: SEE BELOW	DATE: JUNE 11, 1987
APPROVED:	DATE:

SUBJECT: RESPONSE TO AUDIT OF THE AGENCY'S 20% HOUSING PROGRAM

We feel that this management audit should have provided a more balanced review of the 20% Housing Program. Such a review would have recognized the major accomplishments of the past 5 years in committing over $40 million for 2,000 units in nearly 60 separate projects. Continuous planning is important but should not obscure the primary goal of increasing the low and moderate housing supply to meet immediate and present needs. A more balanced approach would also have taken into account that the primary orientation of the program is to develop affordable housing in a timely manner consistent with the Downtown Master Plan and City's General Plan. Under these Plans, moderate income housing is emphasized in the downtown as part of revitalization efforts and retail development and low income housing is provided on a city-wide basis.

It is also important to stress that the 20% Housing Program has been designed as a flexible method of working with the private sector to customize financial assistance for projects not generally economically feasible and to allow for timely adjustments because of changing market conditions.

As a final comment, we feel that while certain improvements in policies and procedures were correctly pointed out by the report, there should have been more recognition of our efforts in the past few months to address these issues. We feel that the audit has brought to light some areas where improvements in the 20% Housing Program can be made. The Agency is committed to implementing these recommendations in a timely manner.

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FINDING I - <u>20% HOUSING PROGRAM PLANNING PROCESS</u>

I. HOUSING NEEDS OF LOW AND MODERATE INCOME PERSONS OR FAMILIES

A. Needs Assessment - Page 12

The needs assessment for the use of 20% funds has been adequate and effective. In addition to the Agency Board discussions and workshops in connection with the adoption of program guidelines, there have been numerous other planning efforts. The City's annual General Plan process includes a housing element and significant needs assessment is conducted through that process. The Agency's program adopts the Housing element as a key planning guide and Agency housing projects are implemented in conformance to the General Plan. In addition, the City Council's workshop held in the December 1985 included significant input from the community, as well as non-profit and for-profit housing organizations, and was extremely valuable in identifying the specific needs of the low and moderate income population.

One good example that came out of that process was the need to address more low income needs in response to a reduction of funding from federal and state sources. The housing guidelines were amended in response to this process to allocate greater amounts to low income housing needs. It should also be noted that the Guadalupe-Auzerais Last Resort Housing process was a very intense citizen participation process that identified the needs of the area residents.

An additional planning process was the Mayor's Homeless Task Force which, with input from the community, assessed the needs of the homeless. This resulted in a very definitive and effective program for funding homeless shelters.

A final area that should be noted is the Agency's participation in the CDBG process primarily through the funding of the various non-profit groups for their administrative and overhead expenses. The review of these groups' funding applications and operations has assisted in the needs assessment process.

B. <u>Proposal Solicitation Process Effectiveness - Page 14</u>

We strongly disagree with the conclusion that the Agency's process impedes effectiveness. The auditor misunderstands the nature of the Agency's process by categorizing it as inherently reactive. What is referred to as a solicitation process is in fact a request for proposals process which has been the very opposite of reactive. Besides advertising for proposals, staff meets with development groups in pre-application meetings to discuss Agency priorities and submittal requirements. A good example is the January 1987 Application Round in which staff very proactively brought in potential developers to explain the recent changes in the Housing Program especially as it relates to the Last Resort Housing for the Guadalupe-Auzerais displacees. Of the approximately $14 million in applications received, over 80% was for low and very low income housing.

C. <u>Unmet Housing Needs - Page 15</u>

The Audit cites the Guadalupe-Auzerais residential displacement activities as a good example of not adequately planning for the housing program. It must be stressed that the relocation program is separate and distinct from and not a part of the 20% Housing Program.

It must be emphasized that there is no legal or administrative requirement that the 20% Housing funds be used to pay the costs of relocation. Such costs were properly included as part of the Guadalupe-Auzerais capital project costs, following standard practice. This resulted in more funds being made available for low and moderate income households.

D. <u>Advantages of the RFP Process - Page 18</u>

The discussion in this Audit about the use of a RFP process is actually with reference to direct Agency land acquisition outside of redevelopment areas. The acquisition of sites is a time consuming process that does not always have the effect of locking in low land prices. Because of statutory requirements, public agencies are not able to move as quickly as the private sector in controlling land as well as negotiating the most favorable price. Consequently, it has been one of the cornerstones of the program to rely on the expertise and speed of both for-profit and non-profit housing organizations.

The program accomplishments already noted in this response makes the point as to the number of units that have been funded through this program since its inception in 1981.

In response to the comments concerning the issue of the Board's policy against land banking and the reference to the December 1985 Housing workshop report statement quoted on Page 19 of the Audit, it should be made clear that the quotation is in the context of redevelopment project areas and can not be used to draw a conclusion that the Agency has had a land banking policy outside of designated redevelopment areas. The Board has generally chosen not to purchase property and has concurred with staff to utilize the concept of working with developers to accomplish housing in as short a time frame as possible.

There are numerous examples of both profit and non-profit developers proceeding rapidly to acquire sites at reasonable prices under the process used by the Program since 1982.

Park Williams. The Santa Clara County Housing Authority obtained the site at a discounted price from a local school district. The Authority sold the site at cost to a private home builder, who constructed moderate priced homeownership housing with Agency assistance.

Parkside. The developer acquired an entire block downtown with Agency loan assistance and land banked it for a condominium development being constructed in four phases.

Amberwood. The developer successfully acquired a site for this 192 unit rental housing project. Agency loan assistance, combined with Housing Authority bonds, were essential to successful project completion.

GUAPA. The nonprofit sponsors for this low income self help housing project successfully achieved site control of already finished lots, thus permitting expediting of construction start.

Chai House. Utilizing Agency loan assistance, the nonprofit housing sponsor, Chai House, Inc. was able to acquire a sufficiently large site for both Phase I and Phase II of this project. The site is excellently located in relation to shopping, public transportation and medical facilities for the residents of this senior housing project.

Inverness Village and Almaden Lakes. The developers were successful in acquiring major sites at an early stage for large scale phased housing developments. Rents and sales prices on later phases were able to be reduced because of Agency assistance and these advance land purchases.

The Agency has been discussing land banking as a possible element of the overall Housing program. This issue is expected to be discussed by the City Council/Agency Board at an upcoming housing workshop. There is a possibility that the concept will be utilized in the future now that new housing has been developed through other mechanisms.

II. LEVERAGING OF HOUSING FUNDS WITH STATE AND FEDERAL FUNDS - Page 20

We take issue with the conclusion about the difficulties of taking advantage of Federal and State Housing money in conjunction with the 20% Housing funds. From the beginning of the program with the initial approvals in 1982, staff has worked very closely with projects that have used both state and federal sources. An analysis of all of the approved projects to date indicates that of the 60 projects, 21 have used some form of federal and state funding. This funding includes everything from Federal Section 8 subsidies through the Housing Authority programs to direct federal loans such as was done in the Chai House I senior project. Federal rental rehabilitation loans have been used on projects such as the Giovanni Center senior project in the downtown.
In addition, California Housing Finance Agency (CHFA) funds have been used for the proposed Vintage Tower project, as well as for homeowner condominium projects such as Inverness Village in the Evergreen area, Palm Street condominiums on Alma Street and the Parkside condominiums at Park and Delmas Street. Federal CDBG funds have been used in conjunction with Federal mortgage assistance and 20% funds for the low income homeownership program in the Canoas Gardens project.

In connection with the reference to the Federal Homeless Housing Legislation, there is already in place a program to pursue available state and federal funds for homeless purposes. This was a key recommendation of the Mayor's Task Force on the Homeless which concluded its deliberations in March 1987. Various non-profit operators are pursuing those funds. This concept has already proven to be successful with the homeless shelters which have been funded in the past few months (Julian Street, Commercial Street, Las

Plumas and Dubert Lane), and will undoubtedly continue to be a very creative method of leveraging Agency funds and effectively meeting the housing needs of this particular population segment.

III. LINKAGES WITH OTHER CITY DEPARTMENTS - Page 23

We acknowledge the importance of improved coordination. However, it is important to point out the coordination efforts in place with the Department of Neighborhood Preservation. Over the past two years, staff has coordinated closely with their rehabilitation program which has not only received Agency funding but is integrated well with the other Agency programs in and around the Central area. The Department of Neighborhood Preservation rehabilitation program focuses on rehabilitation and new construction of four units or less with the Agency's programs focused on larger projects. The Agency has provided funding and coordinated its efforts on the house relocation program from Guadalupe-Auzerais West and has integrated a variety of Agency projects with various funding sources from the Department of Neighborhood Preservation. An example is the Giovanni Center senior project in the downtown through which the Department of Neighborhood Preservation was able to make available a Federal Rental Rehabilitation loan. The Agency has coordinated its efforts closely on the funding of the non-profit housing groups administrative and overhead expenses (formerly an activity funded through Community Development Block Grant). Another example of coordinating activities to maximize resources and opportunities is in the land sale transaction in connection with the Julian Street Homeless Shelter which will soon be under construction. There is also underway a transaction with the Department of Neighborhood Preservation for single family home sites to allow a non-profit group to build detached single family homes for low income families. There has also been an integration of Agency projects with the mortgage revenue bond program administered through the Department of Neighborhood Preservation.

Another linkage between Agency and the Department of Neighborhood Preservation is in the implementation of the Agency's program for meeting last resort housing obligations. Since adoption of that plan, specific staff members from the Agency and the Department of Neighborhood Preservation have been assigned and procedures and a data base have been developed to provide for a well planned implementation effort to build affordable units and effectively place displacees.

IV. HOUSING PROGRAM'S ORGANIZATIONAL PLACEMENT AND MANAGEMENT - Page 26

We recognize the statements in the Audit about the dramatic growth in the size of this program since 1982. The work requirements that have resulted from this accelerated program growth have stretched existing resources and will result in a proposal shortly to address staffing and organization needs. It should be noted that the Housing Program has always been given attention by management from the very beginning. Housing program issues and specific projects have gone through the same process for approval as all other projects within the Agency and have received the same amount and kind of attention as has been given to any other Agency project.

Furthermore, we strongly disagrees with the statement on page 27 citing the use of Agency housing funds primarily as a means in furthering its downtown revitalization efforts in the early stages of the program. While the Program has always been viewed as a means of providing affordable housing downtown in order to implement the objectives of the downtown Master Plan, an analysis of completed projects clearly that many of the early projects were outside of the downtown area and/or were specifically addressed to the low income. Good examples would be the already mentioned Chai House I project outside of the downtown and the Cambrian Center senior housing project. The Joan de Arc project is in the downtown but was addressing itself to a low income need. Another early project was the Canoas Gardens condominium development (Almaden Expressway) that was specifically addressed to low income homeownership.

The following section outlines own specific responses to the recommendations regarding this finding:

Recommendation #1:

Develop and implement a formal assessment process to determine the City's low and moderate income housing needs.

Response:

We will continue to use the general plan housing element, CDBG housing assistance plan process, Agency Board workshops and the Downtown Master Plan update process to assess the housing needs of the City's low and moderate income families.

Recommendation #2:

With the assistance of the Agency Board, the Department of Neighborhood Preservation, community groups, developers, and non-profit corporations develop priorities for addressing the City's most critical low and moderate income housing needs.

Response:

We will continue to make the above noted processes known and accessible to all interested and affected housing entities.

Recommendation #3:

Develop one-year and five-year plans and budgets for addressing the City's most critical low and moderate income housing needs.

Response:

The Agency is developing such plans and budgets.

Recommendation #4:

Assign a higher priority to the 20% Housing Program and elevate it to a higher organizational status within the Agency.

Response:

We are taking steps to strengthen the Housing Division within the Agency. The Agency operating budget now before the Board includes the position of Housing Coordinator and Housing Specialist. The addition of these positions will add increased administrative strength to this program.

FINDING II - CONTROLS OVER THE 20% HOUSING LOAN APPROVAL PROCESS - Page 31

It is recognized that some improvements in this process can increase the effectiveness of the Program. However, we note that the general findings appear to be based upon four projects out of 60 approved by the Board. The Agency has already made or is completing required improvements as noted in the specific responses to Recommendations 5-9.

The Program must be reviewed within the context existing at its inception. The program's goal was to get housing developed where none was being built, due to market conditions, high interest rates and other housing project economic constraints, and with limited administrative costs. This was during a time when Federal housing programs were being reduced and the role of developing new low/moderate income housing became primarily a local responsibility.

Program loans also were designed to be supplements to those made by private lenders. Hence, heavy reliance was placed upon such lenders' normal loan review processes, rather than the Agency setting up a duplicate loan application review apparatus. Further, in earlier projects, other lenders either took most of the risk or the Agency assistance was in the form of homeowner, not project loans.

Increasingly, because of further reductions in Federal and State assistance, increased emphasis on low and very low income housing, and high inner city housing costs, the Agency has greater involvement in project financing and has relatively greater exposure. Therefore, more elaborate loan review procedures and resulting higher staffing levels are required. Formal procedures are now in place or being developed in recognition of this reality.

We question several statements made in connection with discussion of risks.

1. Benefit to Low and Moderate Income Families - Page 34

   The Audit can be interpreted to imply that funds are used to benefit higher income persons. The 20% Housing Program funds committed to date have benefited very low, low and moderate income families defined by State and Federal guidelines as incomes ranging from 50-120% of the County median income. (Currently $24,400-$36,200 for 1-person households.) The issue is whether the funds were used effectively, to benefit these groups. On this issue, the Audit's conclusion appears to be supported by examples of only two projects.

Project #1 - Page 34 - The Agency loaned $1,000,000 to a developer to reduce land acquisition costs, so that lower purchase prices could be achieved for at least 40 moderate income persons or families. The Audit notes two problems with the Agency's analysis concerning the project, (1) the agreement required the developer to significantly reduce the housing unit prices to keep them affordable to moderate income persons, (2) the audit states that the units, at these discounted prices, were probably still too expensive for such persons.

Response: The purpose of the Agency loan was to achieve three bedroom single family detached homes close to places of employment and affordable to moderate income families. The units were determined to be affordable to such families based upon the Agency's normal standard that annual housing costs not exceed 33% of income. Only 5 units have been sold to moderate income persons; the reason was the difficulty in qualifying such families for first mortgage loans for homes at the high end of the moderate income affordability range. The developer loan agreement requires repayment at market rate of any loan funds not applied to moderate income units.

Project #2 - Page 37 - The Agency loaned $500,000 for this rental housing project. The report claims that a more adequate analysis could have resulted in a reduced Agency contribution or more favorable rents for low or moderate income families. The report recommends consistent use of analytical techniques such as internal rate of return analysis.

Response: We recognize that internal rate of return and net present value analyses should be performed on a more consistent basis. However, we disagree with the conclusion concerning this project. The Agency required 50% or 71 of the units at the project to be affordable to moderate income persons. The actual initial rents proposed by the developer are $680 to $745 per month. These rents are under the amounts that would be affordable to moderate income persons. Further, the Agency under the agreement has the discretion to limit rent increases so that unit rents would continue to be below the moderate income affordability limit.

Based on assumptions used in the analysis, the 10 year internal rate of return is in the range of 5.18 to 10.3%. This is considered modest in today's environment.

2. Uncollectable or Undesirable Loans - Page 39

The general statement in this section appears to apply to only two projects.

a) The Audit claims that in one instance, the Agency loaned money without an independent appraisal. This appraisal was not considered by the Auditor to be independent because it was performed by a Board member of a non-profit sponsor/ developer.

   Response: The appraisal met required professional standards and the appraiser was professionally qualified. The appraiser provided this appraisal work at a substantial discount. This practice is consistent with that followed by other non profit organizations as a means of reducing housing cost. Proposed loan review procedures will include requirements for full disclosure of the appraiser's relationship to the applicant. It is now Agency practice to check, verify and analyze appraisals done for various housing development proposals.

b) The Audit states that a $240,000 loan amount approved by the Agency Board for property purchase plus the first mortgage loan was more than 90% of value based upon an appraisal prepared at the time. The report notes that a credit history was not obtained and that the project was funded without the benefit of cost estimates based upon detailed plans.

   Response: Adopted Agency Board policy allows a greater than 90% loan to value ratio if a high percentage of the project units will be affordable to low and very low income persons. This is a low income housing project. In this case, the total indebtedness against the project is approximately 100% of appraised value.

   The Agency did not obtain a credit history, relying instead upon the first mortgage lender's credit judgments, which was the case in the early years of the Program. The Agency now requires all 20% Housing loan applicants to submit credit information and performs credit checks on these applications.

   The Agency reserved funds for the project but did not permit disbursement of construction funds until detailed rehabilitation cost estimates were reviewed. For numerous projects, the Agency has reserved project loan funds and has funded site acquisitions before final cost estimates based on detailed plans are prepared. For the subject property as in similar cases, detailed preliminary cost estimates are required and reviewed prior to disbursement of funds.

There are sound public policy reasons for this approach. Often early Agency approval is critical to obtaining loan commitments from State, Federal, and private sources so that Agency funds can be leveraged to the maximum. Further, early Agency funding of site purchase can result in lower land cost and thus lower sales prices or rents.

3. Sufficient information to properly evaluate loan proposals - Page 44

The Audit proposes use of private lender type Credit Analysis Statements.

Response: The purpose is to ensure compliance with approved policies and procedures and provide necessary information for loan committees to review. The Agency staff has provided a summary on each project (form attached as Exhibit 1), beginning with the January 1987 Application Round. This document achieves the same purpose as the Credit Analysis Statement. It has been adapted to reflect that the Agency is a public purpose lender.

4. Consistency or fairness in evaluating loan proposals. - Page 45

The Audit proposes more complete documentation of the loan analysis process to assure fairness and consistency.

Response: We agree that more complete loan documentation is desirable. Housing loan review staff has periodically received specific instructions defining how it should analyze housing proposals, using the detailed application form and supporting data each developer must provide (Exhibit 2). The Agency's loan analyses are based upon supporting documentation, such as cost and appraisal data. For example, project costs and economics are required to be submitted in a standard format for easier and consistent analysis (Exhibit 2).

Internal loan review forms paralleling those submitted by the applicant are currently being prepared. These forms will provide for supervisory formal sign off in addition to the normal review prior to making recommendations to the Board.

While we recognize the need for documentation to assure consistency of loan proposal analysis, the Program staff does analyze each proposal with respect to the attributes and criteria noted on Page 46. Considerable technical documentation of analyses for loan proposals does exist from most prospects but not always in a form or organization readily accessible and understandable to a non-technical reader.

The following section outlines staff's specific responses to the recommendations regarding this finding and updates the implementation status listed in Table III, p. 32-33.

Recommendation #5:

Develop written procedures for analyzing and approving housing proposals. These procedures should ensure that housing proposals are analyzed consistently and fairly and that 20% Housing funds are used effectively.

Response:

Specific procedures for loan analysis have specific loan analysis and approval instructions have been in place, utilizing the detailed application form and supporting data (Exhibit 2) as a basis. Codifying these procedures in written form is scheduled for completion by Fall 1987.

Recommendation #6:

Provide training to staff on procedures for analyzing and approving housing proposals.

Response:

Staff training regarding evaluation of project loans has occurred. This process will continue as specific procedures are developed.

Recommendation #7:

Periodically review the guidelines that commercial lenders use to qualify buyers for home mortgages. Based on this information, adjust its own guidelines for determining the affordability of proposed housing units to moderate income buyers.

Response:

We will continue periodic review of commerical lenders' housing affordability guidelines for homebuyers. Adjustments to the Agency's affordability guidelines may be made as a result of such review, if appropriate considering the Agency's role as a public purpose lender.

Recommendation #8:

Develop forms for analyzing and approving housing proposals.

Response:

Internal review forms paralleling those submitted by loan applicants are being prepared and will be included in the written loan review procedures scheduled for completion by Fall 1987.

Recommendation #9:

Assign responsibility for reviewing loan analysis and develop forms as a means of establishing accountability over the loan analysis process and subsequent supervisory review.

Response:

Loan analysis review has been assigned to the Senior Development Officer. The recommended internal review forms are being prepared as indicated in the response to Recommendation #8.

Recommendation #10:

Develop and use a Credit Analysis Statement to convey important housing proposal information to Agency management and the Board.

Response:

A detailed project summary has been developed and is being used in place of the recommended Credit Analysis Statement. This summary clearly identifies possible risk factors and other pertinent project loan information.

FINDING III - THE REDEVELOPMENT AGENCY NEEDS TO IMPLEMENT ADEQUATE AND SUFFICIENT CONTROLS TO ENSURE THAT LOAN DOCUMENTS ARE PROPERLY PREPARED. - PAGE 50

We agree with the finding that the 20% Housing Program needs to improve controls to provide greater assurance that loan documents are properly prepared.

In its continual efforts to improve the program, we have taken the following actions to address the potential risks outlined in the Audit. These actions represent an update to the items raised in Table IV, Page 52.

1. With Agency Counsel's assistance, a Truth-In-Lending form was developed recently for specific use in Agency loans. The form will be incorporated in the procedures for document preparation. Staff has scheduled to complete the forms for its past loans by Fall, 1987. Beginning January 1, 1987, the Agency is required by State fair housing law to follow certain procedures and provide information to applicants for home loans. Agency Counsel has prepared written instructions to implement this new legal requirement.

2. Documentation errors of past loans have been identified and corrected. Project developers and homeowner buyers have been contacted to send missing documents to the Agency. Individual as well as master repayment schedules for all loans have been prepared and verified. Individual project and homeowner borrower files have been checked for completeness.

3. A Housing Program Administrative and Loan Management Manual is scheduled for completion in Fall 1987 and will address the recommendations included under Audit Findings II thru IV of the Audit.

Recommendation #11:

Develop and implement written procedures for preparing, reviewing, and approving loan documents.

Response:

Written procedures for approving loan documents prior to fund disbursement have been in effect since September 1986. Written procedures for preparing and reviewing loan documents are being prepared, in cooperation with Agency Counsel. See also response to Recommendation #12.

Recommendation #12:

Formally assign responsibility for preparing, reviewing and approving loan documents.

Response:

Agency Counsel has always been assigned the responsibility for preparing loan documents, circulating them for review by the parties and approving them for legal sufficiency and conformity to Agency policy. Existing procedures assign responsibility for loan document approval.

Recommendation #13:

Develop and consistently use checklists for ensuring that necessary loan documents are properly prepared.

Response:

Agency Counsel provides specific written instructions regarding items needed for proper preparation of loan documents. These instructions will be included in the previously noted Housing Program Administrative and Loan Management Manual.

Recommendation #14:

Develop and use forms for establishing accountability for the preparation, review, and approval of loan documents.

Response:

Forms for establishing accountability for the preparation, review and approval of loan documents will be incorporated in the manual as referenced in Recommendation 13. It should be noted that Agency Counsel sign off on loan documents has always been required.

Recommendation #15:

Develop and use written procedures and necessary forms to comply with the Federal Truth-In-Lending Law and the California Fair Lending law.

Response:

Agency Counsel has prepared the Truth-In-Lending form which will be used on all Agency loans.

Agency Counsel has also prepared written instruction for compliance with the State Fair Lending law, which applies to homeowner loan application received after January 1, 1987.

Recommendation #16:

Develop and use written procedures and necessary forms to ensure that corporate borrowers are properly authorized to borrow in the name of their corporation.

Response:

Procedures and forms that authorize corporate borrowers to borrow in the name of their corporations are being prepared as part of the Program Administrative and Loan Management Manual. Recently, evidence of such authority must be provided in a form acceptable to Agency Counsel prior to each project loan closing.

FINDING IV - THE HOUSING PROGRAM NEEDS TO IMPLEMENT A MONITORING PROGRAM - PAGE 58

We agree with the need for a monitoring element to the Program. Loan monitoring has been consistently done since the inception of the program. Monitoring efforts implemented for the Program involved the use of Construction Management staff to monitor construction progress through completion and thus ensure that construction loan agreements are complied with prior to disbursement of Agency funds. In addition, a number of Agency loans have been combined with the Federal Section 8 program. Such projects with multiple public funding are monitored by the Santa Clara Housing Authority, which has the lead role in monitoring to assure that projects meet low income occupancy and affordability requirements.

We agree that the next step of monitoring borrowers for compliance with the provisions of the Development Loan Agreement (DLA) and the Deed of Trust and Promissory Note is essential to ensure Program integrity. As of November 1986, we have taken the following action to address the problem. These actions should be considered a response and a statement of current status with regards to the items outlined in Table V, Pages 60-61.

1. Written compliance monitoring procedures for both completed project and homeowner loans have been prepared and will go into effect in the Fall of 1987. The proposed compliance monitoring system recommends annual site visits to all projects and the annual sending of registered letters and forms to home- owners certifying their occupancy, and the maintenance of the property including keeping property taxes and fire insurance coverage sufficient and current. The financial records of rental projects will be audited on an annual basis to verify compliance with the project Development Loan Agreement (DLA) requirements such as low and moderate income occupancy and rental affordability requirements.

2. The six rental projects and ten homeowner second mortgage loans that do not have their fire insurance documentation on file with the Agency have been identified. Letters have been sent reminding borrowers of these requirements and requesting that such proof of insurance be provided to Agency housing staff immediately.

Recommendation #17:

Develop and implement written policies and procedures for monitoring borrowers.

Response:

Compliance monitoring policies and procedures for projects under construction have been in effect since September 1986. Such policies and procedures for completed projects and for homeowners are in place and will be codified in written form as part of the Housing Program Administrative and Loan Management Manual scheduled for completion in Fall 1987.

Recommendation #18:

Develop schedules for monitoring borrowers.

Response:

Schedules for annual monitoring of borrowers have been established.

Recommendation #19:

Develop and implement reporting forms for communicating the results of its monitoring visits.

Response:

Monitoring reports are prepared for each project under construction. Reporting forms in connection with the monitoring of housing loans on completed projects and homeowners loans will be put into effect September 1, 1987.

Recommendation #20:

Develop and implement tickler files to remind staff when to monitor borrowers.

Response:

A homeowner loan tickler file system has been established. A similar system for project loans is being prepared and will be put into effect prior to September 1, 1987. As indicated, monitoring all projects and borrowers once annually during the same period of time will reduce the administrative problem of tracking all borrowers.

Recommendation #21:

Develop and implement a management information system to provide feedback on monitoring accomplishments.

Response:

A management information system already exists which enables staff to prepare monthly status reports to the Board. The program's data management is being improved and expanded to better provide such information.

FINDING V - THE REDEVELOPMENT AGENCY NEEDS TO IMPLEMENT ADEQUATE AND SUFFICIENT ACCOUNTING CONTROLS TO SAFEGUARD ITS ASSETS AND PREVENT ERRORS - PAGE 66

We agree that adequate and sufficient accounting controls are necessary to safeguard assets and prevent errors in administering the Housing Program.

Policies and procedures were in place and evolved as the program grew. We have already implemented many of the additional accounting controls recommended during the course of the Audit and are in the process of codifying the procedures. This effort is being coordinated with the Department of Finance.

Need for Accounting Controls - Page 66

Accounting controls are necessary in any program of this type to prevent, detect and correct errors. However, the Audit is incorrect in its assessment of the status of Agency controls (Table VI - page 67). We have taken positive steps, both prior to and during the course of the audit, to address each of the items listed in Table VI. As a result, the status of items 1, 4, 5, 6, and 7 are fully implemented while items 2 and 3 have been partially implemented.

I. STAFF MAY ENGAGE IN IMPROPER ACTIVITIES WITHOUT BEING DETECTED - Page 69

Segregation of functions is a valuable control in protecting against improper activities. The Audit does not discuss the policies and procedures which were developed and implemented to ensure segregation of functional responsibilities. These have been implemented since the inception of the program.

We follow the procedure outlined below in processing each loan, to ensure proper segregation of functions:

1. The Agency Board approves each loan or developer agreement prior to the processing of payment documentation.

2. The Housing unit prepares the original documentation, and retains the original loan agreement in its files. For each payment under the agreement, the Housing unit prepares the appropriate backup documents to justify the amount of the particular payment being requested.

3. The Fiscal Division receives from Housing the complete loan file. The Fiscal Division reviews the file to ensure that documents are properly completed, all necessary documents are present, and the required signatures appear on all documents. The Fiscal Division also maintains a log of all project documents submitted. The documents are then returned to the Housing unit.

4. The payment request is then reviewed by the Fiscal Officer, the Assistant Executive Director, and the Executive Director. This again ensures that the approval of numerous parties is required for any payment to be authorized.

5. Following approval by the above parties, the request for payment is transmitted to the Department of Finance for processing of the check. Again, documents related to the specific payment are reviewed for completeness and accuracy. The Department of Finance also receives a copy of the loan agreement and the original Promissory Note.

6. The Housing unit tracks repayments of the loans, to ensure that payments are received on a timely basis. The Housing unit sends to the Fiscal Division a schedule of anticipated loan repayments. The Fiscal Division receives the actual payment checks directly from the borrower. This is a recent change in procedure, and all borrowers have been notified by mail of the change. A follow up notice is sent to the borrower if payments continue to be received by the Housing unit.

7. The Fiscal Division issues payment receipts and deposits the repayment checks into the Agency account. Copies of the receipts and deposit slips are sent to the Department of Finance, and copies of the checks are sent to the Housing unit. The payment receipts include information on the borrower, the specific loan being repaid, and the payment date.

Functional responsibilities, using this procedure, are segregated among the Housing unit, the Fiscal Division, Agency Management, and the Department of Finance.

B. The Audit suggests that the Agency's practice of placing funds for second mortgages in escrow accounts is inappropriate. Escrow accounts have not been used in this manner since early 1987. In some instances, it will be necessary to utilize escrow accounts. In those few cases, interest will accrue to the Agency. The Agency Fiscal Division and Department of Finance approval will be required to ensure that financial records are accurate.

II. FINANCIAL RECORDS MAY BE MATERIALLY INACCURATE - Page 72

Regular reconciliation of ledgers is essential for proper recording of transactions. The Audit states on page 72 that subsidiary ledgers are not regularly reconciled to the general ledger. Reconciliation of the subsidiary ledger is performed on a regular basis. The second mortgages will now be reconciled on a regular basis.

Peat Marwick's 1984-85 management letter to the Agency stated:

"We suggest that control over the loan population and lending activities be enhanced by establishing a loan subsidiary ledger, to be implemented and maintained by Housing Program personnel. This subsidiary ledger should be periodically reconciled to the general ledger control accounts maintained by the Agency's Accounting Department."

Response to that comment was as follows:

"Agency housing staff will develop the information and subsidiary ledgers required, either manually or in automated fashion, and will reconcile them periodically to the general ledger."

We have fully complied with the recommendations of Peat Marwick, in the manner specified in the management letter. Reconciliations have been performed by the Housing staff since November, 1986. In the future, subsidiary ledgers will be maintained by the Agency Fiscal Division and reconciled with the Department of Finance.

A. Interest Payments Are Not Consistently Calculated - Page 73

The Audit discusses the use of 360-day and 365-day methods of calculating interest payments (page 73). Both the 360-day and the 365-day methods are standard practices in the banking industry. We will use the 360-day method for consistency.

B. Loan Repayments Are Not Being Properly Credited to a Borrower's Account - Page 73

The Audit cited an instance where a borrower is being "overcharged" on his monthly loan repayments. In this isolated case, the borrower calculated his own schedule, and elected to exceed the Agency's minimum payment requirement by $11.28 per month, for a total payment of $610.56 per month. The loan is a $45,000 loan over a term of 15 years.

The excess payment is being applied to the principal, not to interest. The excess payments will result in a shortened payment schedule, reducing the borrower's total interest cost. No actual overcharge is occurring.

C. Improper Accounting for Loans - Page 74

We have corrected the two instances cited in the Audit where loans to the same borrower or project were combined using one payment schedule.

III. IMPORTANT LOAN DOCUMENTS MAY NOT BE ADEQUATELY SAFEGUARDED - Page 75

As noted in the Audit, the Agency locks promissory notes for developments and second mortgage loans in fire-proof cabinets. The report recommends further that all legal documents be similarly protected.

Recommendation #22:

Develop an organization plan which adequately segregates functional responsibilities.

Response:

Functional responsibilities have been segregated between the Housing program, the Fiscal Division, and the Department of Finance to eliminate incompatible functions. This segregation of responsibilities applies to both pre-disbursement and post-disbursement activities, and document control. For instance, in the past some revenue was received by the Housing staff and the Department of Finance. All revenue is now received by the Fiscal Division.

Recommendation #23:

Develop written policies and procedures for all of its accounting activities including the following:

- Maintain custody of assets and important legal documents

- Reconciling general ledger accounts and subsidiary ledgers on a regular basis

- Reconciling records to actual assets on a regular basis

- Calculating interest payments

- Applying repayments to loan accounts

- Accounting for loans

Response:

Procedures addressing most of these items have been in practice for some time, and are in the process of being codified. The current practices with regard to the items listed above are clarified as follows:

- Maintain custody of assets and important legal documents (pages 75-76): There are financial implications associated with the recommendation of storing assets and legal documents in fire proof cabinets.

- Reconciling general ledger accounts and subsidiary ledgers on a regular basis (page 72): Reconciliation has been performed on a regular basis by the Housing staff as recommended in the 1984-85 Peat Marwick audit.

- Reconciling records to actual assets on a regular basis: The contracts were reconciled to the general ledger as part of the 1985-86 annual audit. Reconciliation wil continue on an annual basis as part of the annual audit.

- Calculating interest payments (page 73): Both the 360-day and the 365-day methods are standard in the banking industry. For consistency, the Agency has adopted the 360-day method.

- Applying repayments to loan accounts (page 73): In the case cited by the Auditor, the borrower was not overcharged. Procedures are currently being developed to prevent a similar isolated instance in the future.

- Accounting for loans (page 74): The combining of multiple loans as cited by the Auditor has been corrected.

Recommendation #24:

Develop necessary forms and procedures to ensure that all work is adequately documented and subsequently reviewed.

Response:

The adjustments outlined in response to Recommendations 22 and 23 above will address this recommendation as well.

Recommendation #25:

Provide ongoing training to staff on policies and procedures.

Response:

The segregation of responsibilities discussed in the response to Recommendation 22 will ensure that staff is trained to perform their assigned functions. Training in new procedures is ongoing as new procedures are implemented.

Recommendation #26:

Discontinue the practice of placing money for second mortgages in escrow accounts.

Response:

Our last deposit of funds into an escrow account was for the Pala Ranch Station on February 9, 1987. The Audit does not mention that the practice of depositing to this type of escrow account has not occurred since that date. There are circumstances where the use of this type of escrow account is appropriate. In those few instances, interest will accrue to the Agency and will require the Fiscal Division and Department of Finance approval to ensure that financial records are accurate.

FRANK M. TAYLOR
Executive Director

cc: Gerald E. Newfarmer, City Manager
Les White, Assistant City Manager
Bob Beyer, Deputy City Manager
Joan Gallo, City Attorney
Rita Hardin, Director, Neighborhood Preservation
Gary Reiners, General Counsel, Redevelopment Agency
Sharon Garrison, Director Fiscal & Administrative Services, Redevelopment Agency
Bob Leininger, Director, Project Development, Redevelopment Agency
Tom Cook, Housing Section, Sr. Development Officer, Redevelopment Agency
Ed Schilling, Director of Finance

EXHIBIT 1

REDEVELOPMENT AGENCY OF SAN JOSE
20% Housing Program
Project Summary

Project Name:__________ Location:__________ Developer Name(s):__________

Project Type: Rental_____ For Sale_____ New Construction_____ Rehabilitation_____ Acquisition_____

Type of Unit: Condo_____ Apartment_____ Single Family Detached_____ Townhouse_____ Other_____

No. of Units/Groups Served/Rent/Sales Prices

	Shelter Beds	0 Br.	1 Br.	2 Br-1Ba	2 Br-2Ba	3 Br-2Ba	Totals
1. Very Low Income							
Elderly							
Handicapped/Disabled							
Family							
2. Low Income							
Elderly							
Handicapped/Disabled							
Family							
3. Moderate Income							
4. Market Rate (non-assisted)							
5. Totals							

Project Cost

	Total	Per Sq. Ft.	Total per Unit
1. Land			
2. Construction			
3. Soft Costs			
4. Totals			

% of Agency Loans to Total Project Costs__________

Agency Cost Per Low/Moderate Units__________

Loans to Value Ratio__________

Project Status: Zoning __________ Other Financing: __________

Project Financing

A. Rental Projects ____________________

1. First Mortgage Loan ____________________
2. Developer Equity ____________________
3. Agency Loan ____________________
4. Agency Grant ____________________
5. Other Loans/Grants ____________________
6. Totals ____________________

B. For Sale Projects

1. Construction Loan ____________________
2. Developer Funds ____________________
3. Agency Short Term Financing ____________________
4. Agency Homeowner Loans ____________________
5. Totals ____________________

Proposed Business Terms (in addition to Agency's general loan terms and conditions)

Agency Loan
<u>Construction Loan</u>

Term:

Rate:

Terms of Repayment:

<u>Homeowner Second Mortgage Loans</u>

Term:

Rate:

Terms of Repayment:

<u>Grant</u>:

<u>Maximum Agency Commitments</u>:

Evaluation: (Special features, consistency with Agency goals, potential risks)

EXHIBIT 2

20% HOUSING PROGRAM
PROFORMA SPECIFICATIONS

Development Costs

1)	Building Hard Cost	000
	Building Area Sq. Ft.	000
	No. of Units	000
2)	Other Costs	
	____________________	000
	____________________	000
	____________________	000
	Total Construction Costs	000
3)	Offsite Costs	000
4)	Arch. & Engineering	000
5)	Developer Fee	000
6)	Fees and Surveys, etc.	
	Appraisal	000
	Preliminary Title Report	000
	Bldg Permit Fess	000
7)	Taxes, Insurance, etc.	
	Taxes during Construction	000
	Insurance & Bonds	000
	Legal Fees	000
8)	Land Costs	000
9)	Marketing	000
10)	Rent Up Expenses (if applicable)	000
11)	Financing Carry Costs	
	a) Permanent Lender Fees	
	Loan Amount	000
	Rate	0.00%
	b) Construction Loan Fee	
	Loan Amount	000
	Rate	0.00%
	c) Construction Loan Interest	
	# Months	000
	Loan Amount	0
	Interest Rate	0.00%
	d) Bond Underwriting (if applicable)	000
	e) Cost of Bond (if applicable)	000
	TOTAL DEVELOPMENT COSTS	____________

Redevelopment Agency
City of San Jose
801 N. First Street
San Jose, CA 95110
(408) 277-4744

Project Number________

EXHIBIT 2

Application for Financial Assistance
20% Housing Program

Name of Project		Developer / Contact Person	Phone
Project Location (attachment 1)		Architect	Engineer
Council District	Census Tract	Base Zoning	General Plan

Type of Application
- ☐ Initial request
- ☐ Amendment to appl. approved________________

Type of Project:
- ☐ New Construction
- ☐ Existing
- ☐ Rehabilitation (attachment 3)

Number and Occupancy of Units:

	Senior	Handicapped	Family	Total
Very Low Income				
Low Income				
Moderate Income				
Market Rate				
Total No. Units				

Agency Assistance Requested
Predevelopment Loan $____________
Project Development Loan
Rental Housing Loan $____________
Owner Occupied Housing
Short Term Project Loan $____________
Homeowner 2nd Mortgage Loan $____________

Type of Unit:
- ☐ Apartment
- ☐ Condo
- ☐ Townhouse
- ☐ Single Family Detached
- ☐ Cooperative

Date	Acquisition Price	Total Project Cost	Outstanding Loan Balance
☐ Acquired ☐ Optioned / /	☐ Purchase ☐ Option $____________	$____________ (attachment 2)	$____________

Parcel Size: ____________ Sq. Ft.

No. Units/Acre____________

Type of Construction:
Number of Parking Spaces:____________
Spaces Per Unit:____________

Roofing Materials:
Siding Materials:

Status of Project in Land Use Process:

Is a rezoning required? Yes________ No________ If Yes, Appl. Date________

	Number	Approval Date
PD Rezoning		
PD or SD Permit		
Subdivision Map		
Building or Plan Check		
Building Permit		

Revised March 1986

December, 1986

Attachments to Application for 20% Housing Program Funding

1. Project location map (8 1/2" X 11").
2. Breakdown of predevelopment, construction, financing, and marketing/rent up costs for each project phase.
3. For rehabilitation projects description of proposed work and exterior and interior photos of existing structures.
4. Preliminary title report issued not more than 30 days prior to application submittal.
5. Evidence of site control.
6. Project appraisal or proof of appraisal order.
7. Site plan and elevations (if applicable).
8. For rental housing projects, development cost summary and ten year proforma (sample format attached)
9. Owner occupied Housing Developments Only.
   a. Proposed sales schedule
   b. Price structure analysis (copy attached)
10. Signed financial statement (confidential).
11. Certificate and Qualification of Developer.

FAILURE TO PROVIDE ANY OF THE ABOVE ITEMS WILL RESULT IN DELAYS OR ELIMINATING THE APPLICATION FROM THE CURRENT APPLICATION ROUND.

For predevelopment loan applications, Attachments 5-9 are not required and 2-3 may be preliminary estimates prepared from readily available data.

Owner Occupied Housing

A. Project Budget and Requested Assistance

	Total Amount	Developer	Non-Agency Financing	Agency
Land Acquisition				
Predevelopment Costs: __________ __________ __________ __________ __________ __________				
Construction Hard Costs:				
Financing Costs Construction Interest/Fees Permanent Financing Fees				
Other Costs __________ __________ __________ __________ __________				
Total Project Costs				

Use this area for explanation if necessary

Owner Occupied Housing

B. Unit Specifications and Pricing

	(Indicate Number of Units of Each Type)				
	Studio	____ Bdrm ____ Bath	____ Bdrm ____ Bath	Bdrm Bath	Total
Total No. of Project units					
No. of low income units					
No. of moderate income units					
No. of Market Rate Units					
Sales prices—Low income units					
Sales prices—Moderate income units					
Sales Prices—Market Rate Units					
Unit costs—Low income					
Unit costs—Moderate income					
Unit costs—Market Rate					
Margin—Low income units					
Margin—Moderate income units					
Margin—Market Rate Units					

Owner Occupied Housing
C. Low and Moderate Income Units—Affordability Analysis

	(Indicate Number of Units of Each Type)				
	Studio	______ Bdrm ______ Bath	______ Bdrm ______ Bath	______ Bdrm ______ Bath	______ Bdrm ______ Bath
Sales Price					
Cash Down ______ %					
Agency Take-Out ______ %					
Other Mortgage ______ %					
Annual Housing Costs: 1st Mortgage ______ % Year					
2nd Mortgage ______ % Year					
Hazard Insurance .4% of price					
Taxes 1.2% of purchase price					
Other ______________					
Total Annual Housing Costs					
Minimum Annual Income Required*					
Percent of Median Income** Family Size ______					
Family Size ______					
Family Size ______					
Family Size ______					

*Total housing costs not to exceed 33% of gross income.
**Use chart in developer packet for incomes by family size.

Rental/Housing Project
Affordability Analysis

Very Low Income Units

	(Indicate Number of Units of Each Type)				
	Studio	______ Bdrm ______ Bath	______ Bdrm ______ Bath	______ Bdrm ______ Bath	______ Bdrm ______ Bath
Monthly Rent & No. of Units					
Minimum Annual Income Required*					
% of Median Income** Family Size______					
Family Size______					
Family Size______					
Family Size______					

Low Income Units

	(Indicate Number of Units of Each Type)				
	Studio	______ Bdrm ______ Bath	______ Bdrm ______ Bath	______ Bdrm ______ Bath	______ Bdrm ______ Bath
Monthly Rent & No. of Units					
Min. Annual Income Required*					
% of Median Income** Family Size______					
Family Size______					
Family Size______					
Family Size______					

*30% of gross income allowed for rent & utilities—calculate utility cost at 15¢ per square foot.
**Use chart in developer packet for income levels by family size.

Rental/Housing Project (cont.)
Affordability Analysis

Moderate Income Units

	(Indicate Number of Units of Each Type)				
	Studio	______ Bdrm ______ Bath	______ Bdrm ______ Bath	______ Bdrm ______ Bath	______ Bdrm ______ Bath
Monthly Rent & No. of Units					
Minimum Annual Income Required*					
% of Median Income** Family Size______					
Family Size______					
Family Size______					
Family Size______					

Market Rate Units

	(Indicate Number of Units of Each Type)				
	Studio	______ Bdrm ______ Bath	______ Bdrm ______ Bath	______ Bdrm ______ Bath	______ Bdrm ______ Bath
Monthly Rent & No. of Units					
Min. Annual Income Required*					
% of Median Income** Family Size______					
Family Size______					
Family Size______					
Family Size______					

*30% of gross income allowed for rent & utilities—calculate utility cost at 15¢ per square foot.
**Use chart in developer packet for income levels by family size.

For Project Development Loan Requests

Provide information on loan security and other information on repayment, proposed interest rate, and terms:

Use this section to identify and detail other government financial assistance for which you have applied or will apply (be specific):

Provide specific details of the private financial sources this project will use—in addition, provide the terms and conditions of the construction loan if applicable:

For Project Development Loan Requests (cont.)

List project amenities and standard unit features:

Statement of Qualifications

Completed Projects

Location	Type of Project	Your Role
1.		
2.		
3.		
4.		
5.		

Current and Proposed Projects

Location	Type of Project	Your Role	Status
1.			
2.			
3.			
4.			
5.			

The undersigned certifies that the information herein provided is true and correct to the best of my knowledge and belief.

Signed

Date

Name

20% HOUSING PROGRAM
PROFORMA SPECIFICATIONS

Development Costs		
1)	Building Hard Cost	000
	Building Area Sq. Ft.	000
	No. of Units	000
2)	Other Costs	
	____________________	000
	____________________	000
	____________________	000
	Total Construction Costs	000
3)	Offsite Costs	000
4)	Arch. & Engineering	000
5)	Developer Fee	000
6)	Fees and Surveys, etc.	
	Appraisal	000
	Preliminary Title Report	000
	Bldg Permit Fess	000
7)	Taxes, Insurance, etc.	
	Taxes during Construction	000
	Insurance & Bonds	000
	Legal Fees	000
8)	Land Costs	000
9)	Marketing	000
10)	Rent Up Expenses (if applicable)	000
11)	Financing Carry Costs	
	a) Permanent Lender Fees	
	Loan Amount	000
	Rate	0.00%
	b) Construction Loan Fee	
	Loan Amount	000
	Rate	0.00%
	c) Construction Loan Interest	
	# Months	000
	Loan Amount	0
	Interest Rate	0.00%
	d) Bond Underwriting (if applicable)	000
	e) Cost of Bond (if applicable)	000
	TOTAL DEVELOPMENT COSTS	____________

CERTIFICATE AND QUALIFICATION OF DEVELOPER

20% Housing Program

Development:

Full Legal Name of Developer (sponsor):

Address:

Telephone Number:

The undersigned Developer (Sponsor), in order to induce the Redevelopment Agency of the City of San Jose to consider and approve its housing development financing loan application, hereby certifies as follows:

1. Legal status of Developer (check one):

   ______ Individual
   ______ Partnership
   ______ Corporation
   ______ Business Association or Joint Venture
   ______ Other (Specify) ______________________________

2. If not an individual, Developer was organized on ______________ under the laws of the State of ______________. (Attach as Exhibit A, Articles of Incorporation and Bylaws, Partnership Agreement or other organization document.)

3. If out-of-state organization, is Developer qualified to do business in California? ___Yes ___No

4. In the space provided on the following page, answer the following questions:

   If the Developer is a corporation, set forth the officers, directors, or trustees and each shareowner holding or controlling, directly or indirectly 5% or more of shares of stock.

   If the Developer is a partnership, set forth the partners, and indicate with respect to each member whether he is a general or limited partner, the percentage of his interest, and a description of the character and extent of his interest.

   If the Developer is a business association or a joint venture, list each participant, the percentage of each interest and a description of the characater and extent of his interest.

   If the Developer is some other entity, list the officers, the members with respect to governing body, and each person having an interest of 5% or more.

Name	Resident Address	Title	Interest

5. If Developer will not be the entity owning the Development and receiving the mortgage proceeds:

   A. State the type of entity to be formed and its proposed name.

6. Is Developer required to file periodic reports with Federal Securities and Exchange Commission or any other federal or state agency?

   _______Yes _______No

   If "Yes", attach as Exhibit C copies of the most recent repots filed.

7. Has the Developer ever been declared ineligible to participate in any governmentally assited housing or construction program?

   _______Yes _______No _______UNKNOWN-have never applied for any of the above cited loans

   If the answer is "Yes", give details.

8. If available, provide copy of the FHA Form 2530 describing all previous participation of the Developer, proposed development entity and principals over 100% interest in both the developer and proposed development entity in FHA and other HUD multi-family programs.

9. Except for the property where the proposed development is situated, neither the Developer nor any director, stockholder, officer, employee or agent associated with the Developer, nor any person, firm or corporation having financial interest in the affairs of the Developer has or ever has had any interest in said property, and has not received nor will receive any benefit from the acquisition of said property, including but not limited to rebates, refunds, commissions or fees, except as hereunder disclosed:

____

____

____

10. The Developer has no information that any person, firm, partnership, corporation or joint venture, or any employee of the local, state or federal government, has any financial interest in the real property in question, other than as described in this statement, except as follows: (If "None", so state.)

____

____

____

11. A. Has there ever been filed a petition of involuntary bankruptcy against the Developer? ______Yes ______No

B. Has the Developer ever filed a petition of bankruptcy? ______Yes ______No

C. Has the Developer ever made an assignment for the benefit of creditors? ______Yes ______No

D. Are there any unsatisfied judgments outstanding against the Developer or any of the principals? ______Yes ______No

E. Has Developer been a party to any litigation within the last 5 years? ______Yes ______No

If any of the questions in Paragraph 11 have been answered "Yes", give details:

12. References: Business or Professional (name/address and phone bumber of at least three)

A.

B.

C.

13. Financial Data: Attach as Exhibit B the Developer's latest certified financial statement. The statement should be updated, if necessary, to within t90 days of the date this form is filed with SJRA. If Developer is an individual, signed financial statements not more than 90 days old must be submitted.

14. The undersigned hereby certifies that the information set forth herein, and in any attachments in support thereof, is true, correct and complete to the best of this knowledge and belief.

The undersigned, ______________________________, hereby
(Name)

certifies that he/she is the ______________________________
(Insert name of position or authority

of ______________________________ and is duly authorized

to filed the above statement, and that the information herein is correct and complete to the best of his/her knowledge. I further authorize the Redevelopment Agency of the City of San Jose to order a credit report on me and/or my company.

____
Developer

____
Date

By ______________________________
Signature/Title

1192p/34

PRICE STRUCTURE ANALYSIS: AGENCY ASSISTANCE COMPARED TO NON-AGENCY ASSISTANCE

A. Assumes No Agency Financial Assistance

No. of Units	Sq. Ft. Per Unit	Total Sq. Ft.	Total Cost	Cost Per Unit	Sales Price	Total Revenue	Profit	Margin

B. Assumes Agency Assistance of

No. of Units	Sq. Ft. Per Unit	Total Sq. Ft.	Total Cost	Cost Per Unit	Sales Price	Total Revenue	Profit	Margin

The Redevelopment Agency of the City of San Jose
20% Housing Program

Example of Redevelopment Agency Deferred Payment Loan to Homeowner.

Sales Price of Home	$100,000
10% Down payment	- 10,000
Redevelopment Agency Second*	- 25,000
Maximum First Mortgage Loan**	$ 65,000
Monthly Mortgage Payment	$570
Total Monthly Housing Costs (Taxes, insurance, homeowner fees included)	$703

Estimated total cash required on purchase is $13,200, including down payment and closing costs.

*Deferred interest second loan at 4% for a term of 7 years. Balloon payment of $32,900 due at the end of the seventh year.

**Assumes 30 year fixed rate loan at 10%. Maximum income of family to qualify is $25,300, assuming total monthly housing costs do not exceed one third of this income.

The Redevelopment Agency of the City of San Jose

20% Housing Program

Example of Redevelopment Agency Loan to a Rental Housing Project.

Calculation of Agency Loan Amount

Total Development Cost	$5,000,000
Maximum First Mortgage Loan*	-3,600,000
Developer Equity	- 700,000
Redevelopment Agency Deferred Payment Loan	$ 700,000

*Assume 10% interest, 30 year fixed rate loan; $379,000 (or $399,000 X .95 coverage ratio) available annually for debt service.

Calculation of Agency Loan Repayment

	Year 1	Year 2	Year 3	Year 4	Year 5
Gross Income	600,000	630,000	661,500	694,575	729,304
Less Vacancy Loss (5%)	30,000	31,500	33,075	34,729	36,465
Less Expenses					
Property Taxes	60,000	61,200	62,424	63,672	64,946
Other	111,000	116,550	122,378	128,496	134,921
Net Operating Income	399,000	420,750	443,623	467,678	492,972
Debt Service					
First Mortgage Loan	379,000	379,000	379,000	379,000	379,000
Agency Loan**	-0-	28,000	28,000	50,900	50,900
Net Cash Flow	20,000	13,750	36,623	37,778	63,072

** Redevelopment Agency $700,000 loan is assumed to bear zero interest during construction period and Year 1, 4% interest only for Years 2 and 3 and principal and interest at 4% payable monthly based on a 20 year term starting in Year 4.

NOTE: Assume 5% annual increase in gross income, 2% increase in property taxes, and 5% increase in other expenses.

EXHIBIT 1

REDEVELOPMENT AGENCY OF SAN JOSE
20% Housing Program
Project Summary

Project Name:__________ Location:__________ Developer Name(s):__________

Project Type: Rental_____ For Sale_____ New Construction_____ Rehabilitation_____ Acquisition_____

Type of Unit: Condo_____ Apartment_____ Single Family Detached_____ Townhouse_____ Other_____

No. of Units/Groups Served/Rent/Sales Prices

	Shelter Beds	0 Br.	1 Br.	2 Br-1Ba	2 Br-2Ba	3 Br-2Ba	Totals
1. Very Low Income Elderly							
Handicapped/Disabled							
Family							
2. Low Income Elderly							
Handicapped/Disabled							
Family							
3. Moderate Income							
4. Market Rate (non-assisted)							
5. Totals							

Project Cost

	Total	Per Sq. Ft.	Total per Unit
1. Land			
2. Construction			
3. Soft Costs			
4. Totals			

% of Agency Loans to Total Project Costs__________

Agency Cost Per Low/Moderate Units__________

Loans to Value Ratio__________

Project Status: Zoning __________ Other Financing: __________

Project Financing

A. Rental Projects ____________

1. First Mortgage Loan ____________
2. Developer Equity ____________
3. Agency Loan ____________
4. Agency Grant ____________
5. Other Loans/Grants ____________
6. Totals ____________

B. For Sale Projects

1. Construction Loan ____________
2. Developer Funds ____________
3. Agency Short Term Financing ____________
4. Agency Homeowner Loans ____________
5. Totals ____________

Proposed Business Terms (in addition to Agency's general loan terms and conditions)

Agency Loan
Construction Loan

Term:

Rate:

Terms of Repayment:

Homeowner Second Mortgage Loans

Term:

Rate:

Terms of Repayment:

Grant:

Maximum Agency Commitments:

Evaluation: (Special features, consistency with Agency goals, potential risks)

20% HOUSING PROGRAM
PROFORMA SPECIFICATIONS

Development Costs		
1)	Building Hard Cost	000
	Building Area Sq. Ft.	000
	No. of Units	000
2)	Other Costs	
	____________________	000
	____________________	000
	____________________	000
	Total Construction Costs	000
3)	Offsite Costs	000
4)	Arch. & Engineering	000
5)	Developer Fee	000
6)	Fees and Surveys, etc.	
	Appraisal	000
	Preliminary Title Report	000
	Bldg Permit Fess	000
7)	Taxes, Insurance, etc.	
	Taxes during Construction	000
	Insurance & Bonds	000
	Legal Fees	000
8)	Land Costs	000
9)	Marketing	000
10)	Rent Up Expenses (if applicable)	000
11)	Financing Carry Costs	
	a) Permanent Lender Fees	
	Loan Amount	000
	Rate	0.00%
	b) Construction Loan Fee	
	Loan Amount	000
	Rate	0.00%
	c) Construction Loan Interest	
	# Months	000
	Loan Amount	0
	Interest Rate	0.00%
	d) Bond Underwriting (if applicable)	000
	e) Cost of Bond (if applicable)	000
	TOTAL DEVELOPMENT COSTS	____________

OFFICE OF THE CITY AUDITOR
COMMENTS ON THE AGENCY'S RESPONSE
TO AUDIT OF THE AGENCY'S 20%
HOUSING PROGRAM

The following comments are presented to expand upon, clarify and correct numerous statements in the Agency's *"Response to Audit of the Agency's 20% Housing Program."* We have divided our comments into three categories: General Comments, Comments on Reported Examples, and Specific Comments. We believe the following comments are appropriate, given the content of the Agency's response.

GENERAL COMMENTS

We commenced our audit of the 20% Housing Program in January 1987. On April 16, 1987, at the conclusion of our data gathering process for the 20% Housing Program, we reviewed our potential audit findings with Agency officials, including the Executive Director. In addition, on May 22, 1987, we submitted a draft of our audit report to the Agency and other City officials with a request that they *"...review it for correctness and accuracy..." and "...let me know by June 1, 1987..." if they wished to discuss the draft report with me or my staff. On June 2, 1987, the Agency submitted its "Initial Comments to the May 22, 1987 Draft Audit Report of the Redevelopment Agency 20% Housing Program."* (See ATTACHMENT I) The Executive Director's transmittal letter for these comments stated:

> *"Enclosed is a table outlining the Agency's technical comments with respect to your May 22, 1987 Draft Audit Report. We are meeting with you today, June 2, at 3:00 p.m. to discuss these items in more detail as well as to discuss more general matters in the draft report. Thereafter, we will transmit to you our written response to be incorporated into the final report."*

On June 2, 1987, audit staff met with Agency staff and reviewed the items listed in ATTACHMENT I. Based upon that and several subsequent meetings, all of the "technical issues" were resolved to the satisfaction of the City Auditor's Office and the Agency. The City Auditor issued a revised draft on June 5, 1987, and again requested that the recipients review it for correctness and accuracy and discuss the draft report further with the City Auditor's Office should they wish to do so.

On June 12, 1987, at approximately 3:00 p.m., the Agency delivered its *"Response to Audit of the Agency's 20% Housing Program."* I am disappointed in the Agency's response for two principle reasons. First, at the conclusion of our technical review session, the Agency lead us to believe that the Agency's written response would deal with "philosophical differences" when in fact, much of the response deals with technical and factual issues. Second, I firmly believe that these technical and factual issues would have been resolved had the Agency presented them during the above mentioned technical review meetings. In our opinion, such an approach on the Agency's part would have significantly reduced the volume of their response and eliminated the need to debate the factual content of this report.

Throughout the course of our audit of the 20% Housing Program, audit staff maintained an open and cooperative attitude with the Agency. Audit staff kept the Agency apprised of audit issues as they developed and reviewed reportable information with Housing staff on a current basis. The fact that the Agency implemented some corrective actions during our audit evidences that such interchanges occurred. In short, during this audit, the City Auditor's Office made a genuine good faith effort to deal with the Agency in a forthright, candid and professional manner. Due care was exercised at all times to ensure the accuracy of the final report. Audit staff have documented and supported the information contained in this report. Those items of a factual nature have been reviewed with the Agency and other City Departments. In addition, this report has been subjected to a rigorous internal review process within the Office of the City Auditor to ensure that sufficient, adequate, valid and authoritative evidence exists to substantiate reported statements of fact. I am confident that the Redevelopment Agency Board can rely on the information in this report when making policy decisions for this important Redevelopment Agency Program.

COMMENTS ON REPORTED EXAMPLES

As is pointed out in the *Scope and Methodology* section of this report, we reviewed the Agency's 20% Housing Program to determine if the Agency had implemented adequate and sufficient controls over various aspects of the Housing Program. To the extent Agency controls were inadequate or insufficient, we identified the Agency's resultant exposure to risk. We further provided specific examples to demonstrate that the Agency's risk exposure was real and not merely theoretical. It should be noted that in some instances such reported examples were not all-inclusive but rather only represented some of the situations we noted during our audit. It would be incorrect to assume that during our audit we reviewed all of the Agency's Housing transactions or that we only cited in this report those transactions for which exceptions were noted.

SPECIFIC COMMENTS

Agency Response - Page 2, First Paragraph and Page 7, Last Paragraph

A. Needs Assessment - Page 12

The needs assessment for the use of 20% funds has been adequate and effective. In addition to the Agency Board discussions and workshops in connection with the adoption of program guidelines, there have been numerous other planning efforts. The City's annual General Plan process includes a housing element and significant needs assessment is conducted through that process. The Agency's program adopts the Housing element as a key planning guide and Agency housing projects are implemented in conformance to the General Plan. In addition, the City Council's workshop held in the December 1985 included significant input from the community, as well as non-profit and for-profit housing organizations, and was extremely valuable in identifying the specific needs of the low and moderate income population.

We will continue to use the general plan housing element, CDBG housing assistant plan process, Agency Board workshops and the Downtown Master Plan update process to assess the housing needs of the City's low and moderate income families.

Auditor's Comment

We remain convinced that the Agency needs to establish a formal low and moderate income housing needs assessment process. As was noted on page 13 of our report:

> *"...the CDBG required HAP is not an adequate or sufficient substitute for an Agency 20% Housing needs assessment. The HAP fails as an Agency housing needs assessment because the last City of San Jose HAP was based primarily on 1980 Census information and did not reflect the housing needs of moderate income persons or families, or groups such as homeless persons.*

The Agency could conduct regular and periodic public meetings as one means to assess low and moderate income housing needs. Such meetings could serve as a forum for private citizens, advocacy groups, developers, non-profit organizations and City departments to express their views on San Jose housing needs. The Agency could use the information presented at these public meetings to develop specific plans, procedures, and budgets for future housing projects..."

We believe the above approach is both appropriate and necessary in order for the Agency to develop a formal, integrated and coordinated planning approach for the 20% Housing Program.

Agency Response - Page 3, First Paragraph

B. Proposal Solicitation Process Effectiveness - Page 14

We strongly disagree with the conclusion that the Agency's process impedes effectiveness. The auditor misunderstands the nature of the Agency's process by categorizing it as inherently reactive. What is referred to as a solicitation process is in fact a request for proposals process which has been the very opposite of reactive. Besides advertising for proposals, staff meets with development groups in pre-application meetings to discuss Agency priorities and submittal requirements. A good example is the January 1987 Application Round in which staff very proactively brought in potential developers to explain the recent changes in the Housing Program especially as it relates to the Last Resort Housing for the Guadalupe-Auzerais displacees. Of the approximately $14 million in applications received, over 80% was for low and very low income housing.

Auditor's Comment

The final report now reads:

"...An additional impediment to the Agency effectively planning to meet specific housing needs is the Agency's housing proposal solicitation process....Specifically, the process is more reactive than proactive..." (Page 14).

It should be noted that we do recognize in our report that the solicitation process has resulted in some worthwhile projects. It should also be noted that we are not recommending that the solicitation process be abandoned. Rather, we are recommending that an RFP process be used to meet specific housing needs and that it should be used in conjunction with the solicitation process.

Agency Response - Page 5, Second Paragraph

II. LEVERAGING OF HOUSING FUNDS WITH STATE AND FEDERAL FUNDS - Page 20

We take issue with the conclusion about the difficulties of taking advantage of Federal and State Housing money in conjunction with the 20% Housing funds. From the beginning of the program with the initial approvals in 1982, staff has worked very closely with projects that have used both state and federal sources. An analysis of all of the approved projects to date indicates that of the 60 projects, 21 have used some form of federal and state funding.

Auditor's Comment

It should be noted that most of the 21 projects cited in the Agency's response were funded during the early years of the 20% Housing Program. As we point out on page 20 of our report:

> *"...Federal funds are difficult to acquire and State housing monies have been significantly reduced...The Agency correctly states on Page 2 of its response that there has been...a reduction of funding from Federal and State sources... In our report, we identify several opportunities for the Agency to leverage 20% Housing funds with Federal and State housing monies. We still believe the Agency must plan in order to take advantage of these opportunities."*

Agency Response - Page 7, Second Paragraph

Furthermore, we strongly disagrees (SIC) with the statement on page 27 citing the use of Agency housing funds primarily as a means in furthering its downtown revitalization efforts in the early stages of the program.

Auditor's Comment

The final report has been amended to delete the reference to uses of Agency housing funds in the early stages of the program.

Agency Response - Page 9, Last Paragraph

1. *Benefit to Low and Moderate Income Families - Page 34*

   The Audit can be interpreted to imply that funds are used to benefit higher income persons. The 20% Housing Program funds committed to date have benefited very low low and moderate income families defined by State and Federal guidelines as incomes ranging from 50-120% of the County median income. (Currently $24,400-36,200 for 1-person households.) The issue is whether the funds were used effectively, to benefit these groups. On this issue, the Audit's conclusion appears to be supported by examples of only two projects.

Auditor's Comment

The final report has been amended to read that *"Funds may not be used effectively to benefit low and moderate income families or persons..."* (Page 34). Regarding the number of projects cited, it should be noted that audit staff did not review all of the Agency's loan proposals. In fact, audit staff reviewed 12 of the 47 agreements that had been approved as of December 1986. Further, the two examples cited in our audit report were selected because they were the best, but not the only illustrations of the identified risk.

Agency Response - Page 10, Last Paragraph

Based on assumptions used in the analysis, the 10 year internal rate of return is in the range of 5.18 to 10.3%. This is considered modest in today's environment.

Auditor's Comment

The above internal rate of return relates to a project that the Board approved in June 1986. At no time during our audit did we see any indication that Housing Staff had calculated an internal rate of return for this project. Further, we calculated that the internal rate of return for this project was over 20 percent based upon all of the information that was available at the time of our audit. Finally, the Agency did not provide their calculated internal rate of return for this project to audit staff until June 12, 1987.

Agency Response - Page 11, First Paragraph

2. Uncollectable or Undesirable Loans - Page 39

The general statement in this section appears to apply to only two projects.

a. The Audit claims that in one instance, the Agency loaned money without an independent appraisal. This appraisal was not considered by the Auditor to be independent because it was performed by a Board member of a non-profit sponsor/developer.

Auditor's Comment

The Audit report states that the appraisal was made by a member of the Board of Director's of the non-profit corporation that was the applicant for a $400,000 Agency loan.

Agency Response - Page 11, Fourth Paragraph

Response: Adopted Agency Board policy allows a greater than 90% loan to value ratio if a high percentage of the project units will be affordable to low and very low income persons. This is a low income housing project. In this case, the total indebtedness against the project is approximately 100% of appraised value.

Auditor's Comment

The Agency Board policy provides that:

"...(a) *The sum of the Agency loan and other loans secured by the property shall not exceed 90% of appraised value, except that on a case by case basis the Agency may approve a higher loan to value ratio. Approval of such a ratio would be considered only if one or more the following circumstances exist:...*

...(2) A high percentage of the project units will be made affordable to low or very low income persons;..." (Emphasis added)

At no time during our audit did we see any evidence that this housing project was exempted from the 90% loan to value ratio requirement. Further, the Agency never asserted that this project was exempted from the 90% requirement. Finally, in a January 5, 1987, memorandum to the Agency Board regarding this project, the Agency Executive Director stated in part:

> *"...As an added check and as provided in the Agency loan agreement, the Agency is obtaining its own independent private appraisal of property value after rehabilitation before further funds are disbursed. The appraisal will be completed by a firm that is experienced in appraising rental housing developments. <u>The purpose is to assure that the total of the Agency loan and the first mortgage do not exceed 90% of the appraised value, consistent with terms and conditions approved by the Board June 26...</u>" (Emphasis added)*

<u>Agency Response - Page 21, Third Paragraph</u>

<u>Need for Accounting Controls - Page 66</u>

Accounting controls are necessary in any program of this type to prevent, detect and correct errors. However, the Audit is incorrect in its assessment of the status of Agency controls (Table VI - Page 67). We have taken positive steps, both prior to and during the course of the audit, to address each of the items listed in Table VI. As a result, the status of items 1, 4, 5, 6, and 7 are fully implemented while items 2 and 3 have been partially implemented.

<u>Auditor's Comment</u>

In our opinion, the Agency is incorrect in asserting that items 1, 4, 5, 6 and 7 are fully implemented. Specifically:

- As is stated in our report on Page 70

"...However, our review revealed instances where staff in the Agency's Housing Program were performing all of the following incompatible functions:

- o *Approving loans*
- o *Authorizing payment of Housing funds to borrowers*
- o *Maintaining custody of loan documents*
- o *Maintaining loan subsidiary ledgers*
- o *Calculating interest payments on loans, and*
- o *Receiving payments on loans..."*

It should be noted that the above situation applies specifically to second mortgage loans and to a lesser degree to other aspects of the Program. Further, during our audit, the Agency did not have an organization plan that defined Agency functional responsibilities. Finally, Finance Department officials indicated to audit staff that defining Agency and Department functional responsibilities is both appropriate and necessary.

- The Accounting problems noted in our report do not evidence adequate supervisory review.

- The Agency still does not lock all assets and important legal documents in fire proof cabinets. The Agency seems to concede this point on page 25 of it's response when it states *"...There are financial implications associated with the recommendation of storing assets and legal documents in fire proof cabinets..."*

- During our review, the Agency was not regularly reconciling its general ledger and subsidiary ledgers for second mortgage loans. For example, we identified an instance where the general ledger and subsidiary ledgers for one housing project had not been reconciled for six months and there was an unreconciled difference of approximately $600,000. Further, we found unreconciled differences for four of seven other projects we reviewed.

- On page 25 of it's response the Agency states:

  "...Reconciling records to actual assets on a regular basis: The contracts were reconciled to the general ledger as part of the 1985-86 annual audit. Reconciliation will continue on an annual basis as part of the annual audit..."

  In our opinion, the Agency should not rely on the outside auditors to perform this important function. In addition, these reconciliations should occur more frequently than once a year.

Agency Response - Page 24, First Paragraph

B. Loan Repayments are not Being Property Credited to a Borrower's Account - Page 73

The Audit cited an instance where a borrower is being "overcharged" on his monthly loan repayments. In this isolated case, the borrower calculated his own schedule, and elected to exceed the Agency's minimum payment requirement by $11.28 per month, for a total payment of $610.56 per month. The loan is a $45,000 loan over a term of 15 years.

The excess payment is being applied to the principal, not to interest. The excess payments will result in a shortened payment schedule, reducing the borrower's total interest cost. No actual overcharge is occurring.

Auditor's Comment

We disagree that "no actual overcharge is occurring" and will review this situation with the Agency. Further, it should be noted that this example is the only instance where the Agency is receiving payments based on a monthly amortization payment schedule. Therefore, we believe it is important that the Agency establish procedures so that it will know how to deal with similar situations in the future.

ATTACHMENT 1

CONFIDENTIAL

THE REDEVELOPMENT AGENCY OF THE CITY OF SAN JOSE

June 2, 1987

RECEIVED
JUN 2 1987
CITY AUDITOR

Gerald A. Silva
City Auditor
151 W. Mission
Rm. 109
San Jose, CA 95110

SUBJECT: INITIAL COMMENTS TO THE MAY 22, 1987 DRAFT AUDIT REPORT OF THE REDEVELOPMENT AGENCY 20% HOUSING PROGRAM

Dear Jerry:

Enclosed is a table outlining the Agency's technical comments with respect to your May 22, 1987 Draft Audit Report. We are meeting with you today, June 2, at 3:00 p.m. to discuss these items in more detail as well as to discuss more general matters in the draft report. Thereafter, we will transmit to you our written response to be incorporated into the final report.

Sincerely,

FRANK M. TAYLOR
Executive Director

Enclosure

cc: Gerald E. Newfarmer, City Manager
Les White, Assistant City Manager
Bob Beyer, Deputy City Manager
Joan Gallo, City Attorney
Rita Hardin, Director, Neighborhood Preservation
Gary Reiners, General Counsel, Redevelopment Agency
Sharon Garrison, Director Fiscal & Administrative Services, Redevelopment Agency
Bob Leininger, Director, Project Development Redevelopment Agency
Tom Cook, Housing Section, Sr. Development Officer Redevelopment Agency

2691p/92 101 Park Center Plaza, Suite 1100, San Jose, CA 95113 408 277-5823

ATTACHMENT 1

AGENCY 20% HOUSING PROGRAM MANAGEMENT AUDIT, 5/22/87

CONFIDENTIAL

Page No.	Audit Statement	Response/Proposed Correction
5	First comment, Paragraph 1, third sentence - However, the Agency's agreement with the developer provides that only 90 of the 452 units are actually reserved for low and moderate income families.	150 out of the 452 units in the project are required to be affordable to the low and moderate income families.
5	Second comment, Paragraph 1 - Three for sale projects totaling 84 moderate units have been recently defunded.	The data provided in the table on page 4 is accurate for the period it represents (1982 thru 1986). The three projects totalling 84 moderate units have been defunded by the Board at their 5/7/87 meeting, after the date referred to in the table.
5	Third comment, Paragraph 1 - Eight projects totalling 140 units do not have signed loan agreements.	Six (6) projects do not have signed loan agreements, excluding the May 1987 Board - approved projects. These projects have been approved by the Board and are in the loan documentation and negotiations stage.
5	Fourth comment, Paragraph 1 - The number of for sale housing units is based on the number of second mortgages reserved for homebuyers. However, the Agency actually approved 100 fewer second mortgages than it reported.	The number of for-sale units shown were based upon the amount reserved for specific projects and upon estimates approved by the Agency Board. The estimates are periodically adjusted based upon actual loans closed.
5	Fifth comment, First Paragraph - Our audit revealed that the Agency has no documentation for $225,000 in grants that were supposedly used to construct 235 low income housing units at the Cambrian Center and Jeanne D'Arc apartments.	This entire comment should be deleted. These grants were made in conjuction with Federal loans and rent subsidies for these completed projects. HUD monitors these projects to assure their low income character. The documentation of the original grants approved by the Board is located in the Agency's Board agenda files.

CONFIDENTIAL

AGENCY 20% HOUSING PROGRAM MANAGEMENT AUDIT, 5/22/87

Page No.	Audit Statement	Response/Proposed Correction
5	Last Paragraph, second sentence - The program's staffing was recently increased from 2 to 7 positions: 1 Senior Development Officer, 4 Development Officers, 1 Staff Analyst, 1 Steno Clerk	The Housing Program is now staffed by 8 persons, including a Development Specialist not mentioned in the report.
21	Last Paragraph, heading and first sentence California Housing Finance Authority	This should read The California Housing Finance Agency.
34	Last Paragraph, second sentence - One such project involve the Agency loaning $1 million to a developer to construct 84 single family units.	The Agency loan was used for site acquisition.
35	First Paragraph, second sentence - First, the housing units were too expensive to be affordable for families of moderate income.	The sales prices were affordable to 3-person families at 114% of median, and to 4-person families at 102-110% median. These percentages fall within the 120% of median income affordability limits for moderate income persons and families.

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Page No.	Audit Statement	Response/Proposed Correction
35	First Paragraph, second to the last sentence - Thus the developer had a disincentive of $13,000 per unit (the $16,000 purchase price reduction minus the $3,000 interest savings) to sell to moderate income families.	The project was not negotiated in a way to provide disincentives for selling the units to moderate income buyers. In fact, at the time the Document Loan Agreement (DLA) was signed, the sales prices were affordable to moderate income purchasers and no disincentives existed. Disincentives only occured as a result of cost and price increases in subsequent phases making it more difficult for moderate income purchasers to qualify for loans and private mortgage insurance. Therefore, the Agency loan for subsequent phases was repaid at market rate.
36	First Paragraph, first sentence In return for the use of the $500,000, the Agency only required the developer to keep 50 of the 142 rental units affordable to persons or families of moderate income.	The Development Loan Agreement (DLA) stipulated that 50% or 71 of the units must remain affordable to moderate income persons.
37	First Paragraph, first sentence - According to Agency officials, staff did not have the time to analyze developer profits or rates of return for all housing proposals.	This sentence should read: "According to Agency officials, 1) profit margins on for sale housing projects were reviewed; 2) the internal rate of return analysis is a technique that is applicable only to rental projects sponsored by profit-motivated developers, and; 3) such analysis was performed on a case basis."

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Page No.	Audit Statement	Response/Proposed Correction
39	$240,000 Agency assistance for purchase and rehabilitation.	This was for acquisition only. Another $110,000 was approved for rehabilitation.
51-52	Second Paragraph, last sentence The Agency intended to require the homeowners to pay a penalty if the units where sold to buyers that did not meet the moderate income housing guidelines.	This provision was not intended to be and should not be describe as a "penalty". Penalty provisions in contracts are unenforceable. The provision should be characterized as an "additional charge" intended to recoup the Agency's assistance to the buyer if the unit were sold to a non-qualified buyer.
52	Last Paragraph	The citation to the California to the Health and Safety Code should read Section 35800, et. seq.
53	First Paragraph, third sentence Nevertheless, the Agency is potentially liable for damages as both laws provide penalties for non-compliance.	No state or political subdivision or Agency thereof, is subject to civil or criminal penalties on account of violations of the Truth In Lending Act. 15 U.S.C., Section 1612 (b).
75	Second Paragraph, third sentence - However, the Agency still does not lock second mortgage promissory notes in fire proof cabinets.	All original legal loan documents (Deeds of Trust, and Promissory Notes) for both project and homeowners loans are kept in a fire proof safe located at in the Agency offices at City Hall.

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APPENDIX A

REDEVELOPMENT AGENCY OF THE CITY OF SAN JOSE
20% HOUSING PROGRAM

Revised Program Policies
and Evaluation Criteria
(Adopted February 27, 1986)

I. General Policies

A. In accordance with the California Community Redevelopment Law, at least 20% of the tax increments generated from San Jose's Merged Redevelopment Areas are to be used for the purposes of increasing and improving the community's supply of low and moderate income housing available at affordable housing cost to persons and families of low or moderate income (no more than 80%, and 120% of the Santa Clara County median respectively). In response to this requirement the Redevelopment Agency has established the "20% Housing Program."

B. As a goal, a minimum of 50% of the funds are to be allocated to housing that is affordable to low income persons and families, and the remainder to housing that is affordable to moderate income persons and families.

C. As a goal, 20% of the low income housing funds are to be allocated to housing for which the rents will not exceed the fair market rent levels established for the Federal Section 8 rent subsidy program. The objective is to enable very low income Section 8 rent certificate holders (those with incomes of no more than 50% of County median) to occupy such units at affordable rents.

D. Both owner occupied and rental housing developments are eligible for assistance.

E. As a goal, two-thirds of the funds are to be allocated to new construction developments and one-third to rehabilitation projects (including mobile home parks).

F. The program is intended primarily to stimulate an increase in the supply of housing for low and moderate persons and families. Consideration will be given to providing secondary financing for low and moderate income persons and families who wish to purchase recently constructed unsold dwelling units that meet Agency quality standards. No more than 25% of the new construction allocation (or more-sixth of the total program funds) may be utilized for this program.

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G. Funds are to be allocated to projects which further Central City revitalization and are consistent with City housing policies. Specifically,

1. High rise residential development outside the Central Incentive Zone is discouraged.

* 2. The Agency will provide for the development of low income housing units equal to the number of such units that are located in a Redevelopment project area within the Central Incentive Zone and are removed as a result of direct Agency acquisition or removal. These units are to be developed in reasonable proximity to the Agency project sites, consistent with the availability of development sites suitable for this purpose. Such units will be made available within a reasonable time following the removal of the original units, and the Agency shall use its best efforts to ensure the development of such units within a maximum of four years. In general, housing projects in the Central Incentive Zone with such replacement units shall contain no more than 20% and no fewer than 15% low income units, except that projects with four or fewer total units shall not be subject to this provision.

* 3. Other than the low income units specified in subsection 2. above, low income housing developments generally should be located outside the Central Incentive Zone (see attached boundary map). For low income housing needs, consideration shall be given on a case by case basis to projects (1) in which no more than 20% of the dwelling units are made available for low income persons, and (2) housing for senior citizens.

4. Housing developments, particularly "infill housing", to be located within the Central Incentive Zone and desinged primarily for moderate income persons or families are encouraged.

5. Proposals for housing development to be located outside the Central Incentive Zone will also be considered. In addition, special consideration will be given to projects that are:

   a. Low and moderate "infill" housing, and other moderate income housing to be located in and adjacent to City approved neighborhood business districts and would contribute to their economic and commercial revitalization;

   b. Within the uppper density ranges permitted by the General Plan;

c. Complementary to the City of San Jose's neighborhood preservation programs.

II. Guidelines for Evaluation of Specific Development Proposals

A. The program is designed to be flexible method of addressing the housing needs of low and moderate income families and persons. The Agency has, therefore, attempted to avoid imposition of rigid, arbitrary standards and rankings.

B. Minimum Requirements

1. Proposals must be consistent with the "General Policies" stated above.

2. The proposed housing shall be compatible with the neighborhood and of high quality construction and design.

3. The applicant for Agency funds must have a proven record of successfully completing housing developments that are similar in character to the proposed development.

4. The development must be reasonable in cost and offer a reasonable ratio of costs to selling prices or rents charged.

5. The Agency expects that the developer will make a reasonable cash equity contribution to the project.

6. With respect to rental housing developments, the Agency normally will not loan more than a portion of the developer's cash requirements not included in the primary loan. Also, Agency will require that its assistance result in the achievement of additional units that are affordable to low-moderate income persons and in the maintenance of rents that will continue to be affordable to this group.

7. In general, Agency loans must be secured either by means of a Deed of Trust or by some other suitable means, such as a Letter of Credit.

8. The proposals must provide evidence that the project can begin construction rapidly, normally no more than six months after Agency Board approval. Of special importance is evidence that required governmental approvals and debt and equity financing commitments can be obtained in a timely fashion.

It is recognized, however, that in certain cases, a commitment by the Agency well in advance of other approvals may be essential before a complex project can move forward. In such cases a longer than six month lead time may be acceptable to the Agency.

9. In the case of housing to be rehabilitated, the proposal must demonstrate that the rehabilitated units will continue to be affordable for any existing tenants or that the tenants will be relocated into adequate housing within the person's financial capabilities.

10. In the case of recently constructed unsold or unrented dwellings, the units must be of good quality, meet locational requirements, and otherwise likely to maintain their value. The developer must provide the Agency with a concrete plan for assuring a timely completion of construction and sale or rent of the units. Also, the Agency must be assured that its financial assistance for such housing will not impede the sale or rental of other Agency assisted housing.

11. Normally, the developer is expected to fund predevelopment costs, such as architectural design, option and permit fees, etc. The Agency may, however, approve payment of such costs on a limited case by case basis, provided such payment is critically needed for the project to proceed and the Agency is satisfied that the project can move forward rapidly and meets Agency goals.

C. Ranking of Proposals

Proposals for low income housing to meet Agency determined replacement needs purusant to I.G. 2. above shall have highest priority in consideration. The Agency shall determine such housing needs prior to each round of applications for assistance. In general, all other proposals will receive preference in ranking when they:

1. Achieve a high ratio of private and other public funds to affordable Housing Program funds.

2. Provide for all of the Agency contribution to be repaid and provide further for a rapid payback to the Agency. Grants will be avoided except for projects that otherwise produce a very favorable result for the Agency, for example, a development that attracts a very high ratio of other funds to program funds.

3. Minimize the amount of Agency loan per dwelling until through the use of tax exempt housing bond financing or other means of reducing financing costs.

4. Utilize financial techniques that do not require major commitments of Agency staff time. For example, preference will be given to projects where the primary lender is responsible for loan underwriting and for construction loan administration.

D. Agency Assisted For Sale Housing Developments - Homebuyer Requirements

1. First Time Homebuyer

Normally only those prospective buyers who have not owned a home at any time within three years of purchase of the Agency assisted dwelling unit and who have not so owned other real property shall be eligible for assistance. However, the Agency may make exceptions in certain hardship cases. An example would be a widow or divorcee who was forced to sell her home and who needed Agency assistance to buy a new home.

2. Buyer Commitments

The buyer shall be required to contribute at least a cash down payment of 5% plus closing costs in all cases. Also, if the person or family owns liquid assets that exceed $7,500 plus 5% cash down and closing costs, the excess shall be used to reduce the Agency's second mortgage commitment by $1 for each $2 of Agency money. Liquid assets shall include: cash deposits in financial institutions, certificates of deposit, T-bills, bonds, stocks, mutual funds, notes and similar assets. In addition, a transfer of such assets into less liquid forms within 12 months of an application for assistance shall not be considered effective when calculating buyer cash contributions.

3. Restrictions on Resale and Rental

The Agency imposes certain financial penalties on homebuyers who receive Agency assistance and who either sell the home prior to the maturity of the Agency loan or who rent the home for more than a four month period. The purpose of this requirement is to prevent the owner from realizing a large short term profit on a resale or rental of an Agency assisted unit.

The requirements are as follows:

a) If the property is sold to a non-qualified buyer, the homeowner shall be required to repay the entire Agency permanent loan principal amount plus (1) interest and (2) the cost savings (plus interest at the first mortgage interest rate) resulting from the Agency's financial assistance to the project.

b) In the event that the owner rents the dwelling unit for more than four months, the restrictions indicated under 3.a would apply, except if the buyer can demonstrate the need to rent the unit for a longer period because of financial hardship. An example of such hardship would be an owner who lost his job and could not sell the home because of poor market conditions.

APPENDIX B

December 31, 1986

20% HOUSING PROGRAM
APPROVED PROJECTS

RENTAL HOUSING

PROJECT	LOCATION	DEVELOPER	TYPE OF PROJECT	TYPE OF HOUSING	TOTAL PROJECT UNITS	# OF ASSISTED UNTIS & INCOME GROUPS SERVED TOT.	LOW	MOD.	TYPE OF ASSISTANCE
Completed Projects									
Amberwood	Lundy & Townsend	Davidson, Kavanagh & Brezzo	New Constr.	Family	192	192	38	154	Developer Loan
Cambrian Center	Branham Lane	Cambrian Center Corporation	New Const.	Senior	148	148	148	-0-	Grant
Cedar Glen Apart.	2275 S. Bascom Av.	Davidson, Kavanagh & Brezzo	New Const.	Family	260	260	52	208	Developer Loan
Chai House I	Fruitdale Avenue	Chai House Inc.	New Const.	Senior	70	70	70	-0-	Property Acq. Loan
Home III	1144 Roewill	Housing for Independent People	Rehab.	Handicapped	7	7	7	-0-	Property Acq./Rehab Loan
Home IV	Various	Hsg. for Independent People	Rehab.	Handicapped	7	7	7	-0-	Property Acq./Rehab Loan
Jeanne D'Arc	5th & San Fernando	Archdiocese of SF	New Const.	Senior	87	87	87	-0-	Grant
Naglee Mansion	14th & S. Fernando	Naglee Mansion Associates	Rehab.	Family	17	17	-0-	17	Developer Loan
Transitional Housing	1089 N. 5th Street	Emergency Housing Consortium	Acquisition	Family	7	7	7	-0-	Property Acq. Loan
Transitional Housing II	282 E. Younger	Emergency Housing Consortium	Acquisition	Family	6	6	6	0	Developer Loan
Willow Street	357 Willow	Community Housing Developer	Rehab.	Family	10	10	10	-0-	Property Acq./Rehab Loan
TOTAL					811	811	432	379	
Projects Under Construction									
Chai House II	Fruitdale Ave.	Chai House, Inc.	New Const.	Sr. Housing	70	70	14	56	Developer Loan
Giovanni Center	5th & San Fernando	Giovanni Center, Inc.	Rehab	Senior	24	24	24	-0-	Developer Loan
Hidden Brooks	Wooster Ave.	West Valley Properties	Rehab.	Sr/Family	200	200	80	120	Developer Loan
Satellite Housing	Various	Hsg. for Independent People	Acquisition	Family	9	9	9	0	Developer Loan

Source: Redevelopment Agency

APPENDIX B

PROJECT	LOCATION	DEVELOPER	TYPE OF PROJECT	TYPE OF HOUSING	TOTAL PROJECT UNITS	# OF ASSISTED UNTIS & INCOME GROUPS SERVED TOT.	LOW	MOD.	TYPE OF ASSISTANCE
Projects Under Construction (cont.)									
Vintage Tower	6th & Santa Clara	Aspen Group West	Rehab.	Family	75	75	15	60	Developer Loan
Willow II	339-345 Willow	Community Housing Developers	Rehab.	Family	12	12	12	0	Rehab loan/ 2nd Mortgage
Dorchester Apts.	7th & San Fernando	Metropolitan Housing	Rehab	Family	16	16	16	0	Developer Loan
James Square	390 N. 2nd Street	Barry Swenson Builder	Rehab.	Family	38	38	0	38	Developer Loan
The Cinnabar	1580 Almaden	Amstar Development	New Const.	Family	142	142	0	142	Developer Loan
TOTAL					586	586	170	416	
Other Approved Projects In Process									
Disabled Veterans	1300 Ross Circle	Hsg. for Independent People	Acquisition	Family	4	4	4	0	Property Acq/Rehab Loan
Duane Street Apts.	Duane @ 1st St.	First San Jose Housing Corp.	New Const.	Family	28	28	28	0	Developer Loan
Transitional Housing	1361 Dubert Lane	El Zocalo, Inc.	Acquisition/ Rehab	Family	4	4	4	0	Refinance/Rehab Loan
Vivente I	Meridien & Fruitdale	Hsg. for Independent People	New Const.	Family	28	28	28	0	Developer Loan
Vivente II	Dent Ave & Kooser Road	Hsg. for Independent People	New Const.	Family	28	28	28	0	Developer Loan
TOTAL					92	92	92	0	

Source: Redevelopment Agency

December 31, 1986

APPENDIX B

20% HOUSING PROGRAM
APPROVED PROJECTS

FOR SALE HOUSING

PROJECT	LOCATION	DEVELOPER	TYPE OF PROJECT	TYPE OF HOUSING	TOTAL PROJECT UNITS	# OF ASSISTED UNTIS & INCOME GROUPS SERVED TOT.	LOW	MOD.	TYPE OF ASSISTANCE
Completed Projects									
Canoas Park Townhomes	Canoas Gardens Ave	Community Hsg. Developers	New Const.	Townhouse	45	45	22	23	Construction Loan
Fairview Park	Tully & McLaughlin	Charles Davidson	New Const.	Condo	64	25	25	-0-	2nd Mortgage Loans
Inverness Village	Capitol Expwy & Aborn	A & M Company	New Const.	Townhouse	24	24	-0-	24	2nd Mortgage Loans
Mayfair One	Villa de Guadalupe	A.F. Evans Company	New Const.	Single Fam. Detach	17	17	7	10	Cons.Loan/2nd Mtrg. Loan
Myrtle Place	Myrtle & McKendrie	Fountain Lane Properties	New Const.	Condo	12	12	-0-	12	Cons.Loan/2nd Mtrg. Loan
Palm St. Condos	Alma & Palm	Community Hsg. Developers	New Const.	Condo	28	28	18	10	Land Acq./2nd Mrtg. Loan
Park Williams	3925 Williams Rd.	Circle & Development	New Const.	Condo	60	16	12	4	Land Acq./2nd Mrtg. Loan
St. James Townhouses	6th & St. James	Fountain Lane Properties	New Const.	Townhouse	5	5	-0-	5	Cons.Loan/2nd Mtrg. Loan
TOTAL					255	172	84	88	
Projects Under Construction									
Stonybrook	Lundy & Townsend	A & M Company	New Const.	Single Fam.	84	40	-0-	40	Land Acq./2nd Mtrg. Loan
Boggini Plaza	100 N. 9th Street	Armax Development Corp.	New Const.	Townhouse	7	7	-0-	7	Land Acq./2nd Mtrg. Loan
Chesbro Square	Blossom Hill & Chesbro	Green Valley Corp.	New Const.	Townhouse	45	13	-0-	13	2nd Mortgage Loan
Jefferson Square	San Pedro & Hobson	Jefferson Square Partnership	New Const.	Condo	86	47	-0-	47	2nd Mortgage Loan
Luby Place	Luby Drive	David Smith	New Const.	Condo	24	24	24	-0-	2nd Mortgage Loan
New Horizons	Alma & Vine	Citation Homes	New Const.	Condo	280	95	-0-	95	2nd Mortgage Loan
Orchard Square	Mather Dr. & Jackson	Citation	New Const.	Duets	18	18	-0-	18	2nd Mortgages

Source: Redevelopment Agency

APPENDIX B

PROJECT	LOCATION	DEVELOPER	TYPE OF PROJECT	TYPE OF HOUSING	TOTAL PROJECT UNITS	# OF ASSISTED UNTIS & INCOME GROUPS SERVED TOT.	LOW	MOD.	TYPE OF ASSISTANCE
Projects Under Construction (continued)									
Parkside	Park Ave & Delmas	Fountain Alley Properties	New Const.	Condo	116	60	-0-	60	Land Acq./Const Loan Garage/2nd Mrtg. Loan
St. James Park	3rd & St. James	Gerald J. Grudzen	New Const.	Condo	32	16	-0-	16	Land Acq./2nd Mrtg. Loan
Pala Ranch Station	15th St & Hedding	Charles Knight Assoc.	New Const.	Single Fam.	5	5	-0-	5	2nd Mortgage Loan
TOTAL					697	325	24	301	
Other Approved Projects In Process									
Empire Vista Gardens	Empire between 4th & 5th	Richard Tanaka	New Const.	Condo	5	5	0	5	Land Acquisition/2nd mortgage Loan
GUAPA Self Help	Mc Creary Ave. and Lido Way	PACT/First San Jose Housing	New Const.	Single Family	29	29	29	0	Acquisition and Predevelopment loan/ homeowner 2nd's
Ryland Park	400 N. First Jackson	To be determined	New Const.	To be determined	170	N/A	N/A	N/A	To be negotiated
Sweat Equity	Dent & Kooser Jackson	Housing for Independent People	New Const.	Condo	24	24	24	0	Acquisition and predevelopment Loan
TOTAL					228	58	53	5	

Source: Redevelopment Agency